

**“Islamic” or “Islamizing” Banking Product?  
Reconsidering Product Development’s Approaches  
in the Malaysian Islamic Banking Industry**

Dissertation

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## ABSTRACT

This study critically delves the approaches and challenges in developing Islamic banking products in the Malaysian Islamic banking industry from the perspective of Shari'ah. Specifically, the study examines the concept of product development and the application of Shari'ah in developing Islamic banking products. The study also deliberates on the adequacy of legal and regulatory framework, which aims to ensure the Islamicity of Islamic banking's product development. Finally, the study scrutinizes the issues of *hiyal* (legal artifices) in Islamic banking's product development. In order to integrate the theory and the practice, the study selected three Islamic banks in Malaysia with three products of the banks; namely Maybank Islamic Berhad, Bank Kerjasama Rakyat Malaysia Berhad and Kuwait Finance House (Malaysia). The products chosen are Islamic credit card, Islamic mortgage, and Islamic house financing. The study investigates the Shari'ah contracts applied, Shari'ah legal rulings, the structure and the contentious issues of the products to support the theoretical assumptions discussed in the study. This study utilizes two qualitative methods, namely content analysis and case studies, as the methodology. The study demonstrated that the Islamicity of Islamic banking products is based on the principles of Shari'ah, namely to believe in the Oneness of God (*tawhīd*), to conform to legal principles (*fiqh*) and to embrace the Islamic moral and ethical standards (*akhlāq*). These principles are then transformed to the objectives of Islamic economics and Islamic moral economy that aim to realize the socio-economic objectives and the creation of just and ethical society. Nonetheless, the study found that the current approach taken by Islamic bankers tend to Islamize or replicate conventional products in order to imitate the efficiency and effectiveness of the products, whereas the features of *ribā* (interest/usury) are still saliently existent. This approach only emphasizes on the form rather than the substance of contract, where it could not ensure the Islamicity of Islamic banking products. In this respect, the legal and regulatory framework, which aims to provide the legitimate expediency and efficiency of the product, is still insufficient to support the development of genuine Islamic banking products in parallel with the Shari'ah objectives and Islamic economic principles. Furthermore, the method of *hiyal* has been wrongly used to structure Islamic banking products to circumvent the prohibition of *ribā*. However, not all *hiyal* are categorized under the prohibited *hiyal*, but there are some *hiyal*, which are permitted in the Shari'ah, namely *makhārij* (jurisprudential exits). The method of *makhārij* must be judiciously justified in Islamic banking to avoid the products developed fall under the category of the prohibited *hiyal*. From the three case studies investigated, it was found that Shari'ah issues, such as the issues of combination of contracts, legal, ownership, and *ribā*, are still existent. The results show that the products developed require some improvements in terms of product structures and features in order to portray that they are genuinely Islamic and Shari'ah compliant, which fulfil the requirements of the Islamic economics and Shari'ah objectives.

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Islamic Financial Services Act 2013  
National Land Code 1965  
Real Property Gains Tax Act 1967  
Reciprocal Enforcement of Judgements Act 1958  
Sale of Goods Act 1957 (Amended on 2006)  
Securities Commission Act 1993  
Stamp Duty Act 1949

## A NOTE ON TRANSLITERATIONS AND ABBREVIATIONS

The system of transliterations of Arabic words with diacritical marks is based on the *International Journal of Middle Eastern Studies (IJMES)*. While, for the citations, footnotes, and bibliography of the dissertation are based on *The Chicago Manual of Style (CMS)*, 16<sup>th</sup> Edition. However, there are certain rules about the system of transliterations, which differ from *IJMES* and *CMS*, respectively. With regard to the *ta marbūṭah* in the non-construct state is-*ah*, instead without *h* in *IJMES*. Meanwhile, the total amount of volumes on the refereed books is abandoned in order to simplify the footnote system; instead, it is mentioned in the CMS. Furthermore, this study will retain the Arabic terms, which are commonly used in Islamic banking industry, such as *muḍārabah*, *mushāarakah*, *ijārah* and others in order to preserve the originality of the meaning of the terms. However, an equivalent translation to English of Arabic terms will be provided together in bracket and listed in the glossary. The abbreviations employed in the study, are as follows:

|           |  |
|-----------|--|
| AAOIFI    | : Accounting and Auditing Organization of Islamic Financial Institution        |
| ACWMC     | : Actual Cash Withdrawal Management Charge                                     |
| AIBIM     | : Association of Islamic Banking Institutions in Malaysia                      |
| AITAB     | : <i>Al-ijārah thuma al-bay'</i>   |
| AMMC      | : Actual Monthly Management Charge   |
| AMR       | : All Malaysian Reports  |
| BAFIA     | : Banking and Financial Institution Act 1989                                   |
| BBA       | : <i>Bay' bithaman bi al-ājil</i>  |
| BIMB      | : Bank Islam Malaysia Berhad   |
| BLJ       | : Business Legal Journal   |
| BLR       | : Base Lending Rate  |
| BNM       | : Bank Negara Malaysia   |
| BoD       | : Board of Director  |
| CBMA 2009 | : Central Bank of Malaysia Act 2009  |
| CLA 1956  | : Civil Law Act 1956   |
| CLJ       | : Current Law Journal  |
| CMH       | : Commodity Murābahah House  |
| DCR       | : Displaced Commercial Risk  |
| diss      | : Dissertation   |
| et. al    | : <i>Et alii</i> (Latin)-and others.   |
| FMCWC     | : Fixed Monthly Cash Withdrawal Charges  |
| FMMC      | : Fixed Monthly Management Charges   |
| IAASB     | : International Accounting and Auditing Services Board                         |
| IBA 1983  | : Islamic Banking Act 1983   |
| IBIs      | : Islamic Banking Institutions   |
| IBS       | : Islamic Banking Scheme   |
| IFAMWL    | : Islamic Fiqh Assembly of Muslim World League                                 |
| IIFAOIC   | : International Islamic Fiqh Academy of Organization of the Islamic Conference |
| IFIs      | : Islamic Financial Institutions   |

|        |   |
|--------|---|
| IFRS   | : International Financial Report Services               |
| IFSA   | : Islamic Financial Services Act 2013                   |
| IFSB   | : Islamic Financial Services Board                      |
| INCEIF | : International Center for Education in Islamic Finance |
| IRR    | : Internal Rate of Return                               |
| IRTI   | : Islamic Research and Training Institutions            |
| ISRA   | : International Sharī'ah Research Academy               |
| KFHM   | : Kuwait Finance House Malaysia                         |
| LIBOR  | : London Interbank Offered Rate                         |
| LNS    | : Legal Network Series                                  |
| MIFC   | : Malaysian Islamic Financial Center                    |
| MLJ    | : Malayan Law Journal                                   |
| n.d.   | : No date   |
| n.p.   | : No publisher  |
| NZEC   | : Non-Zero Entry Cost                                   |
| OPR    | : Overnight Policy Rate                                 |
| PER    | : Profit Equalization Reserve                           |
| PLS    | : Profit and loss sharing                               |
| RM     | : Ringgit Malaysia (Malaysian Currency)                 |
| SAC    | : Sharī'ah Advisory Council                             |
| SACBNM | : Sharī'ah Advisory Council of Bank Negara Malaysia     |
| SME    | : Small and Medium Enterprise                           |
| SSB    | : Sharī'ah Supervisory Board                            |
| YPEIM  | : Malaysian Islamic Economic Development Foundation     |
| ZEC    | : Zero Entry Cost                                       |

## GLOSSARY OF ARABIC TERMS

|  |   |
|--|---|
| <i>‘I‘ārah</i>   | : Physical/asset loan   |
| <i>Adillah</i>   | : Legal indications   |
| <i>‘Adl</i>  | : The dispensation of justice   |
| <i>Ajīr khāṣṣ</i>  | : Special worker.   |
| <i>Ajīr mushtarak</i>  | : General worker  |
| <i>Akhlāq</i>  | : Islamic ethics and morality   |
| <i>Al- qawā‘ id al-qaṭ‘īyyah</i>                                 | : Decisive legal ruling   |
| <i>Al-ahkām al- mu‘āmalāt</i>                                    | : The rules of civil transactions   |
| <i>Al-ahkām al-akhlāqīyyah</i>                                   | : The rules of ethics and morality  |
| <i>Al-ahkām al-‘itiqādiyyah</i>                                  | : The rules of faith  |
| <i>Al-‘azīmah</i>  | : Strict rules  |
| <i>Al-bay‘</i>   | : Sale transaction  |
| <i>Al-bay‘ al-mulāmasah</i>                                      | : Touched sale  |
| <i>Al-ghunm bil ghurm</i>  | : Profits goes with loss  |
| <i>Al-ḥassat</i>   | : Pebble sale   |
| <i>Al-ḥiyal al-ḥasanah</i>                                       | : Good ḥiyal  |
| <i>Al-irādah al-bāṭinah</i>                                      | : Inner will  |
| <i>Al-irādah al-zāhirah</i>                                      | : Apparent will   |
| <i>Al-kharaj bi ḍaman</i>  | : The entitlement of profits is due to the risk undertaken  |
| <i>Al-ma‘ārīd al-mubāsharah</i>                                  | : Immediate purpose   |
| <i>Al-maṣlahah al-muṭlaqah</i>                                   | : Absolute public benefits  |
| <i>Al-maṣlahah al-rājiḥah</i>                                    | : Preponderant public interest  |
| <i>Al-maṣlahah mursalah</i>                                      | : Unrestricted public benefits  |
| <i>Al-mutawarriq</i>   | : The buyer   |
| <i>Al-qarḍ al-ḥasan</i>  | : Benevolent loan   |
| <i>Al-qawā‘ id al-fiqhīyyah</i>                                  | : Islamic legal maxims  |
| <i>Al-tawarrūq al-fardī</i>                                      | : Tripartite sale based on individual basis   |
| <i>Al-tawarrūq al-haqīqī</i>                                     | : Genuine tripartite sale   |
| <i>Al-tawarrūq al-maṣrifī</i>                                    | : Banking tripartite sale   |
| <i>Al-tawarrūq al-munazzam</i>                                   | : Organized tripartite sale   |
| <i>Al-warīq</i>  | : Cash  |
| <i>‘Aqd ‘ala manfa‘ah fī al-dhimmah fī syai’ mawsūf bi sifat</i> | : A contract that benefits based on responsibility of something is attributed with specifications |
| <i>Bā‘ith</i>  | : Inducing motives  |
| <i>Bay‘ al- amānah</i>   | : Trust sale  |
| <i>Bay‘ al-ajal</i>  | : Deferred sale   |
| <i>Bay‘ al-ṭinah/ ṭinah</i>                                      | : Double sale/sale and repurchase   |
| <i>Bay‘ al-istiṣnā’/ istiṣnā’</i>                                | : Commission sale   |
| <i>Bay‘ al-kālī bi al-kālī</i>                                   | : Sale of debt with debt  |
| <i>Bay‘ al-madāmin wa al-malāqih</i>                             | : Sale of what is in the loins and wombs  |
| <i>Bay‘ al-ma‘dum</i>  | : Sale of something that is not one’s possession  |
| <i>Bay‘ al-murābahah/ murābahah</i>                              | : Sale at cost plus mark-up   |
| <i>Bay‘ al-musāwamah/ mu-</i>                                    | : Negotiation sale  |

|                                       |  |
|---------------------------------------|--|
| <i>sāwamah</i>                        |  |
| <i>Bay‘ al-muzāyadah</i>              | : Bidding sale                                       |
| <i>Bay‘ al-salam/salam</i>            | : Forward sale                                       |
| <i>Bay‘ al-takjiri</i>                | : Financial lease                                    |
| <i>Bay‘ al-tawlīyyah/ tawlīyyah</i>   | : Sale at cost price                                 |
| <i>Bay al-‘urbūn/ ‘urbūn</i>          | : Earnest money                                      |
| <i>Bay‘ al-waḍī‘ah</i>                | : Selling at a price lower than the first purchase   |
| <i>Bay‘ al-wafā</i>                   | : Sale of redemption                                 |
| <i>Bay‘ bithaman al-ājil</i>          | : Sale and purchase with deferred payment            |
| <i>Bay‘ atayn fī bay‘ah</i>           | : Two sales in one sale                              |
| <i>Ḍarūriyyat</i>                     | : Essentials   |
| <i>Ḍiyānatan</i>                      | : Religious obligations                              |
| <i>Fatwā</i>                          | : Verdict  |
| <i>Fiqh</i>                           | : Islamic law  |
| <i>Fuqahā</i>                         | : Muslim jurists                                     |
| <i>Ghalaṭ</i>                         | : Mistake  |
| <i>Gharāmah</i>                       | : Fine/penalty                                       |
| <i>Gharar</i>                         | : Uncertainty  |
| <i>Ghubn</i>                          | : Inequality   |
| <i>Ḥabal al-ḥabalah</i>               | : The offspring of an unborn animal                  |
| <i>Hadiyah</i>                        | : Present  |
| <i>Ḥajiyyāt</i>                       | : Necessities  |
| <i>Ḥalāl</i>                          | : Permissible  |
| <i>Hamish jidīyyah</i>                | : Security deposit for promissory undertaking        |
| <i>Ḥarām</i>                          | : Prohibited   |
| <i>Ḥikmah</i>                         | : Wisdom   |
| <i>Ḥiwālah</i>                        | : Debt transfer                                      |
| <i>Ḥiyal</i>                          | : Legal artifices                                    |
| <i>Ḥiyal maḥmudah</i>                 | : Permissible legal artifices                        |
| <i>Ḥiyal muḥarammah</i>               | : Prohibited legal artifices                         |
| <i>‘Ibādat</i>                        | : Devotional matters                                 |
| <i>Ibrā’</i>                          | : Waiver/rebate                                      |
| <i>Idh‘ān</i>                         | : Adhesion   |
| <i>Ijārah</i>                         | : Lease  |
| <i>Ijārah al-dhimmah</i>              | : Lease contract on the form of liability            |
| <i>Ijārah mawsūfah fī dhimmah</i>     | : Forward lease                                      |
| <i>Ijārah muntaḥiyah bi al-tamlīk</i> | : Lease end with ownership                           |
| <i>Ijārah thuma al-bay‘</i>           | : Hire-purchase                                      |
| <i>Ijārah wa al-iqtinā’</i>           | : Lease end with acquisition                         |
| <i>Ijārah wāridah ‘ala al-dhimmah</i> | : Lease contract based on responsibility             |
| <i>Ijmā’</i>                          | : The consensus of jurists                           |
| <i>Ijtihād</i>                        | : Exertion of personal effort to deduce legal ruling |
| <i>Ijtimā‘ī</i>                       | : Social welfare sector                              |
| <i>Ikrāh</i>                          | : Duress   |
| <i>‘Illah</i>                         | : Effective cause                                    |

|                              |  |
|------------------------------|--|
| <i>Irādah</i>                | : Will   |
| <i>Istighlāl</i>             | : Unfair exploitation                              |
| <i>Istiḥsān</i>              | : Juristic preference                              |
| <i>Istiṣḥāb</i>              | : Presumption of continuity                        |
| <i>Istiṣnā' mawāzī</i>       | : Parallel manufactured sale                       |
| <i>Ju'ālah</i>               | : Payment of a specific reward for a task          |
| <i>Kafālah</i>               | : Guarantee  |
| <i>Kafārah</i>               | : Penance/expiation                                |
| <i>Kāfil</i>                 | : Guarantor  |
| <i>Khiyār</i>                | : Option   |
| <i>Khiyār al-'ayb</i>        | : Option of defect                                 |
| <i>Khiyār al-tadlīs</i>      | : Option of fraud                                  |
| <i>Lāzim</i>                 | : Binding  |
| <i>Madhhab</i>               | : School of Islamic law/legal school in Islam      |
| <i>Mafsadah</i>              | : Harmful  |
| <i>Majlis al-'aqd</i>        | : Contractual session/meeting                      |
| <i>Makhārij</i>              | : Jurisprudential exits                            |
| <i>Makrūh</i>                | : Reprehensible                                    |
| <i>Makrūh tahrim</i>         | : Reprehensible action closest to the proscription |
| <i>Maqāṣid al-Sharī'ah</i>   | : The objectives of Sharī'ah                       |
| <i>Ma'qūd 'alayh</i>         | : Subject matter                                   |
| <i>Maṣlahah</i>              | : Public interest                                  |
| <i>Maysir</i>                | : Gambling   |
| <i>Mu'āmalāt</i>             | : Civil transactions                               |
| <i>Mubah</i>                 | : Neutral  |
| <i>Muḍārabah</i>             | : Silent partnership                               |
| <i>Muḍārib yuḍārib</i>       | : Two-tier silent partnership                      |
| <i>Muftī</i>                 | : Jurist consult                                   |
| <i>Mukallaf</i>              | : Capacitated person                               |
| <i>Munābadhah</i>            | : Thrown sale                                      |
| <i>Munākahāt</i>             | : Personnel status                                 |
| <i>Muqāṣṣah</i>              | : Off-set of the debt                              |
| <i>Mushārah</i>              | : Active partnership                               |
| <i>Mushārah mutanāqīṣah</i>  | : Diminishing partnership                          |
| <i>Niyyah</i>                | : Intention  |
| <i>Qadā'an</i>               | : Juridical obligations                            |
| <i>Qarḍ</i>                  | : Loan   |
| <i>Qaṣd al-Sharī'</i>        | : Purpose of the legal provisions                  |
| <i>Qawā'id</i>               | : Methods  |
| <i>Qawā'id al-Sharī'yyah</i> | : Methods of legal deduction                       |
| <i>Qīmī</i>                  | : Non-fungible                                     |
| <i>Qiyās</i>                 | : Analogical reasoning                             |
| <i>Rahn</i>                  | : Mortgage   |
| <i>Ribā</i>                  | : Usury/interest                                   |
| <i>Ribā al-buyū'</i>         | : Usurious sale                                    |
| <i>Ribā al-faḍl</i>          | : Usurious sale of excess                          |

|                                     |   |
|-------------------------------------|---|
| <i>Ribā al-nasī'ah</i>              | : Usury due to defer of payment   |
| <i>Rukḥṣah</i>                      | : Concession/alleviation  |
| <i>Sabab</i>                        | : Cause   |
| <i>Ṣadaqāh</i>                      | : Charity   |
| <i>Sadd al-dharā'ī</i>              | : Blocking the means  |
| <i>Salam mawāzī</i>                 | : Parallel forward sale   |
| <i>Shahādah</i>                     | : Testimony that Only Allāh is the God and Muḥammad is the Messenger of Allāh |
| <i>Shubhah</i>                      | : Obscurity   |
| <i>Siyāsī</i>                       | : Public sector   |
| <i>Ṣukūk</i>                        | : Investment certificate/Islamic bond   |
| <i>Sunnat</i>                       | : Recommended   |
| <i>Taḥawwul</i>                     | : Transformation  |
| <i>Tahgrīr</i>                      | : Fraud   |
| <i>Taḥsiniyyāt</i>                  | : Embellishments  |
| <i>Takāful</i>                      | : Islamic insurance   |
| <i>Tawarrūq</i>                     | : Tripartite sale   |
| <i>Tawarrūq al-fiqhī</i>            | : Juristic tripartite sale  |
| <i>Tawhīd</i>                       | : Faith   |
| <i>Ta'wīḍ</i>                       | : Compensation  |
| <i>Tijāri</i>                       | : Private sector  |
| <i>Ujrah</i>                        | : Fee/wage  |
| <i>'Uqūd ghayr lāzim</i>            | : Non-binding contracts   |
| <i>'Uqūd lāzim</i>                  | : Binding contract  |
| <i>'Uqūd musamma</i>                | : Nominated contracts   |
| <i>'Urf</i>                         | : Customary practice  |
| <i>Wa'd</i>                         | : Unilateral undertaking/promise  |
| <i>Wa'd bi bay'</i>                 | : Unilateral undertaking/promise to sell                                      |
| <i>Wa'd bi shirā</i>                | : Unilateral undertaking/promise to purchase                                  |
| <i>Wa'd mujarad</i>                 | : Promise without cause   |
| <i>Wa'dān</i>                       | : Two unilateral undertaking  |
| <i>Wadī'ah</i>                      | : Safekeeping   |
| <i>Wadī'ah yad amānah</i>           | : Safekeeping with trust (without liability)                                  |
| <i>Wadī'ah yad ḍamānah</i>          | : Safekeeping with guarantee(with liability)                                  |
| <i>Waḥy</i>                         | : Divine revelation   |
| <i>Wajīb</i>                        | : Obligation  |
| <i>Wakālah</i>                      | : Agency  |
| <i>Waqf</i>                         | : Endowment   |
| <i>Wasā'il</i>                      | : Means   |
| <i>Waṣīyah</i>                      | : Will  |
| <i>Waṣīyah bi al-manfa'ah</i>       | : Will to use benefit   |
| <i>Zawāhir al-nuṣūs al-haqīyyah</i> | : Explicit definitive texts   |



## INTRODUCTION

### 1. Background

The growth of the Islamic banking industry has continued to gain momentum with its total asset is increasing at a tremendous pace. The world's leading professional services organization, Ernst & Young (2013) estimates the global Islamic banking assets are USD\$ 1.7 trillion in 2013 (USD\$1.54 trillion in 2012). In this regard, the Kingdom of Saudi Arabia (KSA) dominates 16% of the shares, where Malaysia is in the second place with its assets are 8% of the total Islamic banking assets globally. This is followed by other Muslim countries, such as the United Arab Emirates (5%), Kuwait (4%), Qatar (3%), and Turkey (2%).<sup>1</sup>

Malaysia has been considered as the most progressive country promoting Islamic banking industry. Malaysia was the first Islamic country in the South East Asia that established the first Islamic bank, namely Bank Islam Malaysia Berhad (the BIMB) in 1983.<sup>2</sup> To ensure its sustainability, the government awarded a monopoly status to the BIMB for 10 years for the bank to improve its operations and business activities. During the first decade of its establishment, the BIMB had made a significant progress in terms of profitability and return. From 1984 to 1997, it sustained a 21 percent of average profit, even though it lagged behind the conventional banks, which had an average record of 36 percent of profit. However, it still was an impressive achievement for a new model of banking.<sup>3</sup>

In 1993, Bank Negara Malaysia (BNM), i.e. the Central Bank of Malaysia introduced the “Islamic Banking Scheme” (IBS) to speed up the dissemination of Islamic banking products to local customers within the shortest possible period. As a result, it allowed conventional banks to participate in offering Islamic banking products through their existing facilities. There were 24 conventional banks, which responded to the call

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<sup>1</sup> Earnings and Young, “The World Islamic Banking Competitiveness Report 2013–14,” accessed on 28 December 2013, <http://emergingmarkets.ey.com/wp-content/uploads/downloads/2013/12/World-Islamic-Banking-Competitiveness-Report-2013-14.pdf>

<sup>2</sup> Nik Norzul Thani, Mohamed Ridza Abdullah and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance* (Singapore: Sweet & Maxwell Asia, 2009), 21; see also Sudin Haron, *An Overview of Islamic Banking System in Malaysia*, Kuala Lumpur Business School, accessed on 10 October 2011, <http://www.klbs.com.my/Pdf/country%20rpt%20MAL.pdf>.

<sup>3</sup> Abdus Samad and M. Kabir Hassan, “The Performance of Malaysian Islamic Bank during 1984-1997: An Exploratory Study,” *International Journal of Islamic Financial Services* 1, no. 3 (Oct-Dec.1999):1-14.

and provided Islamic banking products through their 1663 branches.<sup>4</sup> The IBS is required to set up a division responsible for the Islamic banking operations, such as product development, marketing, risk management and credit control. Furthermore, the Islamic banking division also should be led by a Muslim senior manager who possesses relevant background in Islamic banking and banking experience.<sup>5</sup>

After the 1997 financial crisis, the landscape of Islamic banking in Malaysia has changed. To speed up the progress of the Islamic banking industry, the government allowed the establishment of the second Islamic bank, Bank Muamalat Malaysia Berhad in 1999. Following the Financial Sector Plan that was introduced in 2001, the BNM began to close down IBS branches and encouraged the scheme to be transformed to be fully Islamic banking entities. This transformation aims to further strengthen the Islamic banking industry towards achieving a 20 percent of total banking market share by 2010. Newly established Islamic banks must be led by a Chief Executive Officer that has a greater autonomy in running their business. This allows Islamic banks to expand the business to local and international depositors and investors through direct equity participation. By December 2013, 8 IBS banks have been transformed into full Islamic banking institutions.

Furthermore, BNM has taken a next step in 2005, to liberalize the local Islamic banking industry market by allowing foreign Islamic banks to operate in Malaysia. The foreign banks are expected to offer new products and services to customers and to create a healthy competition among the local Islamic banks as driving forces for growth. Since 2011, three foreign Islamic banks, Al-Rajhi Banking and Investment Corporation (Malaysia) Berhad, Kuwait Finance House (Malaysia) Berhad, and Asian Finance Bank Berhad have commenced their operations in Malaysia. In order to monitor and regulate the activities and operations of the Islamic banks, three acts have been legislated (see figure 1). Currently, 16 full Islamic banks have been established in Malaysia and regulated under the Islamic Financial Services Act 2013 (the IFSA 2013).<sup>6</sup> Meanwhile, there are other Islamic banking institutions, namely Bank Kerjasama Rakyat Malaysia

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<sup>4</sup> Norma Md. Saad, *Macro Economic Application in South East Asian Countries* (Kuala Lumpur: International Islamic University of Malaysia Press, 2004), 52; Amir Sharifuddin, "A Study on Muḍārabah in Islamic Law and Its Application in Malaysian Islamic Banks," (PhD diss., University of Exeter, 2010), 159.

<sup>5</sup> Bank Negara Malaysia, "Guidelines on Skim Perbankan Islam," accessed on 30 September 2013, [http://www.bnm.gov.my/guidelines/01\\_banking/04\\_prudential\\_stds/28\\_spi.pdf](http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/28_spi.pdf).

<sup>6</sup> List of Islamic banks in Malaysia accessed on 29 November 2011, [http://www.mifc.com/index.php?ch=menu\\_know\\_ibt\\_ib&pg=menu\\_know\\_ibt\\_ib\\_list](http://www.mifc.com/index.php?ch=menu_know_ibt_ib&pg=menu_know_ibt_ib_list).

Berhad<sup>7</sup> and Agrobank Berhad<sup>8</sup> are regulated under the Development Financial Institution Act 2002 (thereafter DFI 2002). In addition, conventional banks are also allowed to open Islamic banking schemes, which are regulated under the Financial Services Act 2013 (the FSA 2013) and the IFSA 2013, respectively.<sup>9</sup>

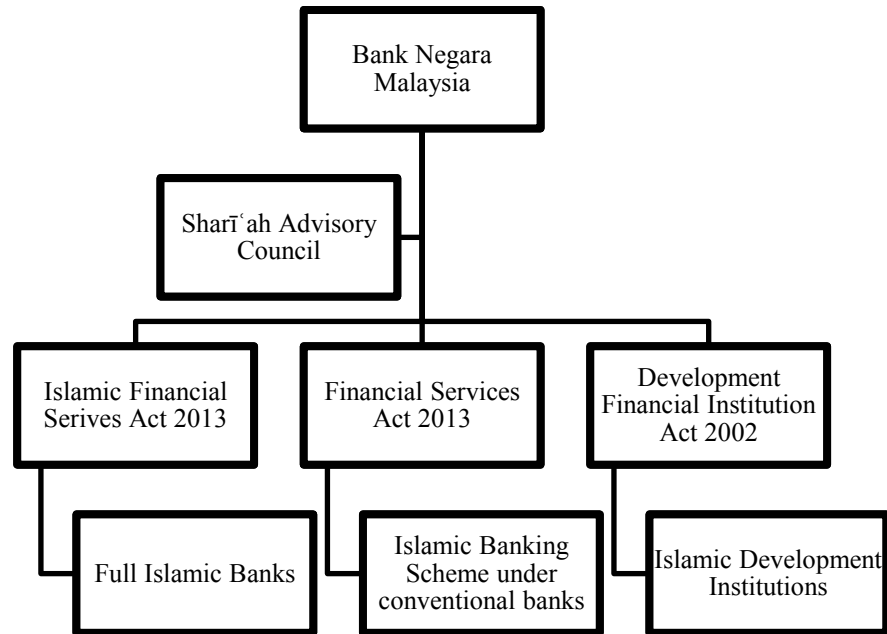


Figure 1: The Structure of Regulation and Supervision of Islamic Banks in Malaysia

| No. | Name of the Bank  |
|-----|---|
| 1.  | Affin Islamic Bank Berhad                                     |
| 2.  | Al Rajhi Banking and Investment Corporation (Malaysia) Berhad |
| 3.  | Alliance Islamic Bank Berhad                                  |
| 4.  | AmIslamic Bank Berhad   |
| 5.  | Asian Finance Bank Berhad                                     |
| 6.  | Bank Islam Malaysia Berhad                                    |
| 7.  | Bank Muamalat Malaysia Berhad                                 |
| 8.  | CIMB Islamic Bank Berhad                                      |
| 9.  | Hong Leong Islamic Bank Berhad                                |
| 10. | HSBC Amanah Malaysia Berhad                                   |
| 11. | Kuwait Finance House (Malaysia) Berhad                        |
| 12. | Maybank Islamic Berhad  |
| 13. | RHB Islamic Bank Berhad                                       |
| 14. | Standard Chartered Saadiq Berhad                              |
| 15. | Public Islamic Bank Berhad                                    |
| 16. | OCBC Al-Amin Bank Berhad                                      |

Table 1: List of Islamic Banks in Malaysia

<sup>7</sup> It is also known as Bank Rakyat.

<sup>8</sup> The bank was formerly known as Bank Pertanian Malaysia Berhad.

<sup>9</sup> Unfortunately the lists of conventional banks that are permitted to run Islamic banking scheme are not provided by the Central Bank.

The government has taken many initiatives to facilitate the development of Malaysian Islamic banking system. This includes the establishment of the Malaysian Islamic Financial Center (MIFC) in 2006. MIFC is as a central hub for Islamic finance and engages with various financial institutions and organizations to strengthen the industry. To increase the human capital and talent in Islamic finance, various tertiary institutions have offered courses from bachelor to PhD level, as well as professional degree. To strengthen research and development of Islamic financial services, the government established the International Sharī'ah Research Academy (ISRA) in 2008, which focuses on the aspect of Sharī'ah research in Islamic finance.<sup>10</sup>

The government also has developed new and various regulations, laws, and governance system of Islamic banking in order to support the industry. Among the recent initiative is to amend the Central Bank of Malaysia Act 1959 and it was replaced with the Central Bank of Malaysia Act 2009 (thereafter CBMA 2009). The new amendment of the act has given more power to the Sharī'ah Advisory Council of Bank Negara Malaysia (thereafter SACBNM) to interpret Sharī'ah. Because of the amendment, the civil courts are now required to consult with the SACBNM before deciding any matter related to Islamic banking and financial issues and cases. Various guidelines and Sharī'ah resolutions have been issued by BNM to strengthen the operations of Islamic banking.

In this respect, various factors contribute to its growth and advancement, and one of the reasons is the innovation of numerous Islamic banking products in the market.<sup>11</sup> It is a state of creating a new financial product, which aims to reduce cost and risk as well as to satisfy the client's needs. New products are the means for a financial institution in gaining market share, ensuring the viability and efficiency of firms and achieving competitive advantages.<sup>12</sup> It also contributes to economic growth, since the banking and financial sectors provide financing for production and consumption activi-

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<sup>10</sup> For example, the International Center for Education in Islamic Finance (INCEIF) was established by Bank Negara Malaysia in 2006 to train students in various Islamic finance subjects by offering graduate courses. Tan Sri Dr. Zeti Akhtar Aziz, "Focus on Human Capital Development in Malaysia," (Welcoming remarks at INCEIF strategic Partnership 2006, Kuala Lumpur, 14 December 2006)

<sup>11</sup> Ibid. see also Monzer Kahf, "Success Factors of Islamic Banks: An Empirical Study," in *Islamic Banking and Finance Fundamentals and Contemporary Issues*, edited by Salman Syed Ali and Ausaf Ahmad (Jeddah: IRTI, 2004), 121-168; Monzer Kahf, "Islamic banks at the threshold of the third millennium," *Thunderbird International Business Review*, 41, no. 4-5 (July - October 1999): 445-460; Mushtak Parker, "Innovation Key to Success of Islamic Finance Industry," *Arab News*, accessed on 12 April 2012. [www.arabnews.com/node/395015](http://www.arabnews.com/node/395015).

<sup>12</sup> Luisa Anderloni and David T. Llewellyn (editors), *Financial Innovation in Retail and Corporate Banking* (Cheltenham, UK; Northampton, MA, USA: Edward Elgar, 2009), x.

ty. Hence, the only way for financial institutions to gain a sustainable growth and competitive advantage within the rapidly changing financial environment is to engage in an endless battle of product innovation and development.<sup>13</sup>

Financial and banking institutions develop new products to achieve many purposes, such as to transfer risk, provide liquidity in the economy, as well as generate revenues from credit and equity. These led to four specific types of banking products; namely risk-transferring, liquidity-enhancing, credit-generating and equity-generating products. Risk-transferring products refer to new instruments that allow economic agents to transfer the price or credit risk in financial claims among banking institutions. Meanwhile, liquidity-enhancing innovations refer to the products that can increase the marketability, negotiability and transferability of existing financial instruments or represent new instruments with enhanced liquidity properties. On the other hand, credit-generating products are the products that can broaden the access of economic agents to credit supplies. Finally, equity-generating products refer to the innovations that can expand the economic agents to equity finance.<sup>14</sup>

In the same vein, Islamic banking institutions (IBIs) also take the same path to develop products that are based on the above classifications. If conventional financial institutions employ interest-based as the underlying principle, IBIs have to find an alternative method to develop products are based on the Sharī'ah compliant manners, since interest or *ribā* was prohibited. Product developers in Islamic banks have to think creatively in developing a product, which is consistent with the Sharī'ah principles and the modern requirements of banking so that the products would be viable in the market.

## 2. Problem Statement

While the Islamic banking industry is expanding with various products and services offered in the market, nonetheless there are many queries have been raised by scholars regarding the features and structures of the Islamic banking products. Recent studies have shown that Islamic banking products have been criticized due to the prod-

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<sup>13</sup> Edward Gardner, Barry Howcroft and Jonathan Williams, "The New Retail Banking Revolution," *The Service Industries Journal* 19, no. 2 (1999): 83-100.

<sup>14</sup> The Bank for International Settlements (BIS), *Recent Financial Innovations in International Banking* (Basel: BIS, 1986), 169-170.

ucts appear to be mirroring conventional products. El-Gamal (2006) for example asserted that the approach taken to replicate conventional products lead to the economic inefficiency of the industry due to additional legal and jurist fees.<sup>15</sup> Some of the scholars argued that product developers in Islamic banks only emphasize the legalistic forms to fulfill the contractual requirements rather than the substances of the contracts. Salem (2006), for example observed that Islamic banks do not practice what they preach, where they all charge interest, but disguised it in an Islamic concept. The banks engage in deceptive and dishonest banking practices.<sup>16</sup> Holden (2007) labelled Islamic banking as a legal hypocrisy's institution, where many modern techniques of Islamic banking are not strictly Sharī'ah compliant and are actually very similar to conventional banking.<sup>17</sup>

Despite the initiatives taken by the Malaysian government to strengthen legal and regulatory framework, it has been observed that there are still many challenges in implementing Islamic banking industry. Halim (2011), for example argues that among the challenges are the incompatibility of national law to the Sharī'ah law, differences of legal jurisdiction of court in adjudicating Islamic banking cases and less exposure and knowledge of civil court's judges to the Sharī'ah law.<sup>18</sup> Furthermore, there are many cases have been brought to the court in order to challenge the legality of Islamic banking product to the Sharī'ah principles.<sup>19</sup>

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<sup>15</sup> Muḥammad A. El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge: Cambridge University Press, 2006), 25.

<sup>16</sup> Muḥammad Saleem, *Islamic Banking: A \$300 Billion Deception* (Bloomington, IN: Xlibris Corporation, 2006), 1-5.

<sup>17</sup> Kelly Holden, "Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern," *Boston University International Law Journal* 25 (2007): 341-368; see also Haider Ala Hamoudi, "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance," *Chicago Journal of International Law* 7, no. 2 (2007): 605-622; Haider Ala Hamoudi, "Muḥammad's Social Justice or Muslim Cant: Langdellianism and the Origins of Islamic Finance," *Cornell International Law Journal* 40, no.1 (2007): 89-133.

<sup>18</sup> Civil courts administer cases related to civil commercial transactions, whereas Sharī'ah courts only administer personel and private cases, such as marriage and inheritance, which are restricted as compared to civil courts. See Mustafa 'Afifi bin Ab. Halim, "Enhancing the Effectiveness of Legal Infrastructure: A Study on Legal Issues and Other Challenges of Islamic Banking and Finance in Malaysia," 1-14 (paper presented at 8th International Conference on Islamic Economics and Finance, Qatar, December 19-21, 2011)

<sup>19</sup> See *Bank Islam Malaysia Berhad v Lim Kok Hoe and Anor and Other Appeals* (2009) 6 CLJ 22; *Bank Islam Malaysia Bhd v Adnan Omar* (1994) 3 CLJ 735; *Dato' Hj Nik Mahmud Daud v Bank Islam Malaysia Bhd* (1998) 3 CLJ 605; *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd* (2003) 1 CLJ 625; *Affin Bank Berhad v Zulkifli Abdullah* (2006) 1 CLJ 438; *CIMB Islamic Bank Bhd v LCL Corporation Bhd and Anor* (2011) 7 CLJ 594; *Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Berhad and Another Case* (2010) 4 CLJ 388; *Tinta Press Sdn Berhad v Bank Islam Malaysia* (1987) 1 MLJ 474; 1 CLJ 474.

The employment of *hiyal* (legal artifices) for product development has further increased the criticism over Islamic banks.<sup>20</sup> The method has been used, as a device to modify the conventional banking products and it has turned out to be the prototype for developing Islamic banking products.<sup>21</sup> The legality of *hiyal* has been disputed by Muslim jurists over its permissibility in the Sharī‘ah, where some of Islamic jurisprudential schools have allowed, others are not.<sup>22</sup> The demarcation of opinions vis-à-vis the application of *hiyal* has complicated the process of product development. Besides, it has been contended that the method will also endanger the objectives of Sharī‘ah of Islamic banking. Furthermore, *hiyal* contribute to a bad perception among the public that the Islamic banks are merely imitating conventional products in the market to produce Islamic banking products.<sup>23</sup> From the foregoing, it is observed that the above problems require an analytical study to examine the root issues and challenges in developing Islamic banking products and to recommend some proposal to improve the problems.

### 3. Research Question

From the foregoing problem statement, several questions can be asked in this regard. Firstly, what is the concept of product development from Islamic banking per-

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<sup>20</sup> *Hiyal* (sing. *hīlah*) are legal means by which one can arrive at judicial outcome that was prohibited by the Sharī‘ah law. It is the use of legal methods for extra-legal ends, legal, or illegal, to be achieved directly with the means provided by the Sharī‘ah. See Joseph Schacht, “*hiyal*,” in *the Encyclopaedia of Islam*, edited by B. Lewis, V. L. Menage, CH. Pellat and J. Schacht (Leiden: Brill, 1986), vol. III, 510-513; Joseph Schacht, *An Introduction to Islamic Law* (Oxford: Oxford University Press, 1983), 78-79; Mohd. Daud Bakar and Engku Rabiah Adawiah Engku Ali, *Essential Reading in Islamic Finance* (Kuala Lumpur: CERT, 2008), 113-130, 133-165.

<sup>21</sup> See for example Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance, and Prospects* (UK: Palgrave Macmillan, 2005), 24; Imran Ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking* (Islamabad: Niazi Publishing House, 2000), 88-95.

<sup>22</sup> The Ḥanafī and Shāfi‘ī’s legal schools of thought generally accept the mechanism applied in Islamic law, the Mālikī and Ḥanbalī’s school of thought reject them. For further information, see chapter 4.

<sup>23</sup> Contemporary scholars also criticized the use of legal artifices in Islamic finance and banking. See Parvez Ahmed, “The Current Economic Crisis - Is Islamic Finance a Solution?” accessed on 26 December 2013, [http://www.huffingtonpost.com/parvez-ahmed/the-current-economic-cris\\_b\\_516965.html](http://www.huffingtonpost.com/parvez-ahmed/the-current-economic-cris_b_516965.html); Muḥammad Nejatullah Siddiqi, “Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art,” *Islamic Economic Studies* 13, no. 2 (2006): 1-48; Volker Nienhaus, “Capacity Building in the Financial Sector: Strategies for Strengthening Financial Institutions,” 1-26 (paper presented at An Inaugural Islamic Financial Stability Forum, Khartoum, Sudan - 6 April 2010); Simon Archer and Rifaat Ahmed Abdel Karim, “Accounting Standards for Islamic Financial Services,” *Handbook of Islamic Banking*, edited by M. Kabir Hasan and Mervyn K. Lewis (Cheltenham, UK; Northampton, MA, USA: Edward Elgar, 2007), 303; Killian Bälz, “Breaking the Formalist Deadlock- Islamic Finance and Socially Responsible Investment,” (paper presented at the 8th Harvard University Forum, on Islamic Finance: Innovation and Authenticity, Harvard University, Cambridge, 19-20 April, 2008).

spective? The inquiry is made to identify the principles that underlie the process of product development. Another question is to which extent the legal and regulatory framework can support the process of product development in the Malaysian Islamic banking. The process of product development of Islamic banking involves very complex legal structures, which must take into consideration of the Sharī'ah requirements, the national laws, and the changes that happened in the legal infrastructure of Islamic banking industry. Finally, what is the role of *hiyal* in developing Islamic banking product, and to which extent the concept is allowed in the Sharī'ah.

#### **4. Objective**

The objectives of the study are as follows:

- (i) To examine the concept of product development and Sharī'ah application in Islamic banking,
- (ii) To scrutinize the legal and regulatory constraints in structuring Islamic banking products from Sharī'ah perspective in the Malaysian context,
- (iii) To assess the juristic problems of *hiyal* in product development, and
- (iv) To analyze some products from selected Islamic banks in Malaysia to illustrate the approaches and issues in developing Islamic banking products.

#### **5. Methodology**

This study is predominantly based on the qualitative approach. The approach is deliberately selected because the method is able to explore the phenomenon of product development of Islamic banking from its rich environment and context. This was explained by Denzin and Lincoln (2000) that qualitative study is a unique approach to study a phenomenon in its natural setting, to make it sensible and to interpret the phenomenon in terms of the meanings from the people that bring it. It engages the use of a variety of empirical materials and sources, such as case studies, personal experiences, thoughts, life stories, interviews, and observational, historical, interactional, and visual texts that describe routine, problematic moments and meanings in individuals' or societies' lives. The researchers that use qualitative approach will organize a wide range of loose methods, hoping always to get a better understanding on the subject matter at



hand.<sup>24</sup> In order to acquire the information, numerous methods have been used including but are not limited to, interviews, group discussions, observation and field notes, documents, texts, and pictures.

In order to study the concept of Sharī'ah and product development, this study prefers to employ content or textual analysis written about the topics. As explain by Denzin and Lincoln (2000), content analysis is able to describe the substance, principles, standards, structure, and functions of messages, ideas, implications and lessons contained in texts, which have been used by social scientists.<sup>25</sup> Hence, this study will extract the principles, standards and framework of Sharī'ah and product development discussed in the texts. Among the texts that will be examined are academic articles published in peer-reviewed and established journals, theses, legal documents of Islamic financing, Sharī'ah resolutions and standards as well as classical and contemporary texts of Sharī'ah.

Meanwhile, to examine the legal and regulatory challenges in developing Islamic banking products, the study relies on the acts and statutes, legal documents, cases, legal books, and academic papers related to Islamic banking. In Malaysia, the banking industry is highly regulated; hence, any Sharī'ah resolutions, guidelines and circulars issued by the BNM are binding to the industry. Each procedure and process for the introduction of a new product must be followed and presented to the BNM. Therefore, the study fully utilizes these sources, which are available in the form of official publications issued by the BNM, either in the form of hardcopy or softcopy available in its official website. Furthermore, the study also relies on "Sharī'ah Resolutions of Islamic Finance" issued by the SACBNM that comprises of a collection of *fatwā* in order to examine the Sharī'ah decisions related to Islamic banking. In addition, other standards and guidelines issued by international Islamic standard settings, such as the Accounting and Auditing Organization of Islamic Financial Institution (the AAOIFI) based in Bahrain and the Islamic Financial Services Board (the IFSB) based in Kuala Lumpur are also references for the study. These guidelines serve as a comparative benchmark be-

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<sup>24</sup> N. K. Denzin, and Y. S. Lincoln, "Introduction: Entering the Field of Qualitative Research," in *Handbook of Qualitative Research*, edited by N. K. Denzin N K and Y. S. Lincoln (London: Sage, 1994), 1-17; N. K. Denzin, and Y. S. Lincoln, "Introduction: The Discipline and Practice of Qualitative Research," in *Handbook of Qualitative Research*, edited by N. K. Denzin and Y. S. Lincoln (Thousand Oaks, CA: Sage, 2000), 1-28.

<sup>25</sup> Denzin, and Lincoln, "Introduction: Entering the Field of Qualitative Research," 225.

tween Malaysian and global standards, where the Malaysian regulatory authority also adopted some of these standards.

To study the notion of *hiyal*, this study largely refers to various classical and contemporary scholarly works related to *hiyal*. The primary references for *hiyal* are mainly based on the Qur'ān and the Prophetic traditions, which have been extracted and presented into specific themes and rulings by medieval and contemporary Muslim jurists. The sources can be found in various classical and contemporary Islamic law's books and journals. These books and journals are examined in order to ascertain the position and applicability of *hiyal* in Sharī'ah. Furthermore, the study also is restricted to examining the position of *hiyal* within the four Sunni traditions, namely the Ḥanafīs, Mālikīs, Shāfi'īs and Ḥanbalīs, whereas the Shi'īs positions of *hiyal* are excluded from the analysis, since Shi'īs views are not accepted in Malaysia and not in line with the Sunni traditions. In addition, the position of Malaysian Sharī'ah scholars on *hiyal* is also discussed.

As the propositions of product development in Islamic banking has been established, the study will examine the real cases of Islamic banking products in order to integrate the theory and practice. This study employs multiple case studies, as a strategy rather than a single case study. This method is preferred because it allows for a detailed explanation of each case and the drawing of substantial conclusion while avoiding a superficial cross-case comparison either design, approach or style of the product. In comparison, a single case study may not be representative of the population from which they are drawn, particularly, when a range of behaviors, or profiles, experience, outcomes or situations is desirable.<sup>26</sup>

In this regard, the study chooses three Islamic banks, namely Maybank Islamic Berhad, Bank Rakyat Malaysia Berhad and Kuwait Finance House (Malaysia) Berhad, which may represent different category of Islamic banks in Malaysia. The first Islamic bank, Maybank Islamic Berhad is regarded as the largest Islamic bank in Malaysia and it is a subsidiary of the largest conventional bank in Malaysia; Maybank group. This bank practices dual banking system; conventional and Islamic banking. The bank is under the legal jurisdiction of Islamic Financial Services Act 2013. Meanwhile, Bank

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<sup>26</sup> Robert. K.Yin, *Case Study Research: Design and Methods* (California: Sage Publication, 2003) 1-2; TESOL International, "Qualitative Research: Case Study Guidelines," accessed on 17 October 2013, <http://www.tesol.org/read-and-publish/journals/tesol-quarterly/tesol-quarterly-research-guidelines/qualitative-research-case-study-guidelines>

Rakyat Malaysia is selected because it is a full Islamic bank, where its establishment is aimed to assist the cooperative institutions in Malaysia. The bank is established under the concept of mutual system among the cooperative institutions in Malaysia. This bank is under the jurisdiction of the Development Financial Institutions Act 2002. The third bank, Kuwait Finance House is an Islamic foreign bank that was given a license by BNM to operate in Malaysia. It is hoped, that the admission of the bank will bring its vast experience from the Middle East into the local Islamic banking industry to create a competitive environment between the local Islamic banks. The variety of the banks and products selected may provide various ideas and insights about how the Malaysian Islamic banks develop their products.

These three banks offer many Islamic banking products; hence, it is necessary for this study to select specific products, which are able to add new input, and to assist with providing a wealth of information to facilitate and answer the research questions of this study. In this respect, the three products chosen are Islamic credit card facility, Islamic mortgage, and Islamic house financing under the concept of forward lease (*ijārah mawsūfah fī dhimmah*). These products were selected for several reasons.

The Islamic credit card is selected because it is considered a relatively new product in Malaysian Islamic banks, although it has long been offered by the conventional banks. Islamic banks are considered to be lagging behind because of the difficulties they faced in finding a structure that was Sharī'ah compliant while at the same time it satisfies the banking and customers' requirements. As such, many Islamic banks postponed offering the product until they can find a viable structure that is consistent with the Sharī'ah principles. However, some Islamic banks have offered the product, in order to reap the advantage of being the first mover in the market. Nevertheless, they also could not resolve Sharī'ah issues that haunted the concept, structure, and approach of the product.

The second product is chosen because *rahn* has been regarded, as a solution to finance working capital for small and medium enterprise (SME) and personal financing. The first impression is that Islamic banks have resolved the Sharī'ah issues involved. However, their Sharī'ah structure has been consistently criticized by some scholars. Hence, it is required to examine the concept and Sharī'ah issues involved.

The third product is selected because Islamic house financing under forward lease is considered a new structure proposed as an alternative house-financing scheme in Malaysia. Since it is a new product, which is not established in the market yet, not

many Islamic banks attempted to introduce the structure as an alternative to other products of house financing like BBA or *murābaḥah*. Therefore, it is worth to examine the concept and issues related to the product.

## 6. Rationale

It is observed that the existing scholarly works regarding product development in Islamic banking are still limited and the existing literature only provide a narrow perspective, which only focuses on the processes of product development, without analyzing the contextual circumstances of Islamic banks. Hence, it is important for this study to address this gap by examining the crucial issues of the concept and approach, the legal and regulatory constraints and legal artifices in developing Islamic banking products. At the end, this study will attempt to explain the justification and reason, why Islamic bankers adopt such approach in the bank.

Furthermore, by investigating the Malaysian Islamic banking products, the study is expected to provide rich information about the present state of the approaches and processes undertaken in developing Islamic banking products. In addition, the Islamic banking industry in Malaysia also includes the range of fully-fledged Islamic banks as well as conventional banks offering an Islamic banking window. The competitive environment created by this dual banking system is argued to have resulted in the availability of a wide range of sophisticated products from banks offering Islamic banking operations.

This study does not examine a specific contract, such as *murābaḥah*, *muḍārabah*, or *mushārah*, as a tool for product development, because such an examination would restrict the focus of product development to one type of contract and approach. Instead, this study intends to emphasize a general proposition of the theoretical ideas and their practical application of product development in Islamic banks. This approach is purposely selected to give a general idea on what are the approaches, designs, and structures adopted by Malaysian Islamic banks to develop their products. Since Islamic banking products have been labelled with the mimicking of conventional products, therefore it is important to discern why such approach is adopted and what the mechanism is used to mimic it.

## 7. Research Gaps

Most studies of product development identified were started from conventional perspective, in both manufacturing and services industries, which emphasized on key determinants or antecedents that contributed to the success of product development.<sup>27</sup> The focus is more on what steps that firms must execute and models that can support the development process.<sup>28</sup> Meanwhile, other studies focus on determinants that separate winners from losers of product innovation such as a clear product definition,<sup>29</sup> a differentiated product with unique customer benefits,<sup>30</sup> and sufficient market knowledge.<sup>31</sup> Additionally, important organizational issues such as working with and listening to lead users,<sup>32</sup> the involvement and cooperation of multiple functions during the development process,<sup>33</sup> the use of flexible organizational structures and cross-functional teams,<sup>34</sup> communication processes,<sup>35</sup> the overall execution of the project,<sup>36</sup>

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<sup>27</sup> Vermeulen and Raab (2007) have conducted an extensive literature review on studies of product development in banking and insurance companies. Hence, this study has benefited of the useful information about the past studies related to innovation and product development provided by the authors. See Patrick Vermeulen and Jorg Raab, *Innovations and Institutions: An Institutional Perspective on the Innovative Efforts of Banks and Insurance Companies* (Abingdon: Routledge, 2007).

<sup>28</sup> R.G. Cooper and E.J. Kleinschmidt, "New Products: What Separates Winners from Losers?" *Journal of Product Innovation Management* 4, no. 2 (1987): 169–184; R.G. Cooper, "From Experience. The Invisible Success Factors in Product Innovation," *Journal of Product Innovation Management* 16 (1999): 115–133; R.G. Cooper, S. Edgett and E. Kleinschmidt, "Optimizing the Stage-Gate Process: What Best-Practice Companies Do," *Research Technology Management* 45, no. 5 (2002): 21–27.

<sup>29</sup> R.G. Cooper "New Product Strategies: What Distinguishes the Top Performers?" *Journal of Product Innovation Management* 2 (1984): 151–164; Cooper R.G. and U. De Brentani, "New Industrial Financial Services: What Distinguishes the Winners", *Journal of Product Innovation Management* 8, no. 2 (1991): 75–90.

<sup>30</sup> U. De Brentani, "Success and Failure in New Industrial Services," *Journal of Product Innovation Management* 6, no. 3 (1991): 239–258; U. De Brentani, "Success Factors in Developing New Business Services," *European Journal of Marketing* 25, no. 2 (1991): 33–59; R.G. Cooper, C.J. Easingwood, S. Edgett, E.J. Kleinschmidt and C. Storey, "What Distinguishes the Top Performing New Products in Financial Services," *Journal of Product Innovation Management* 11, no. 4 (1994): 281–299.

<sup>31</sup> D. Thwaites, "Organisational Influences on the New Product Development Process in Financial Services," *Journal of Product Innovation Management* 9, no. 4 (1992): 303–313; U. De Brentani, "Innovative Versus Incremental New Business Services: Different Keys for Achieving Success," *Journal of Product Innovation Management* 18, no. 3 (2001): 169–187.

<sup>32</sup> E. Von Hippel, *The Sources of Innovation* (Oxford University Press: New York, 1988); D. Leonard Wellsprings of Knowledge. *Building and Sustaining the Sources of Innovation* (Boston: Harvard Business School Press, 1998).

<sup>33</sup> R.K. Moenaert and W.E. Souder, "an Information Transfer Model for Integrating Marketing and R&D Personnel in New Product Development Projects," *Journal of Product Innovation Management*, 9(1) (1990): 91–107; A. Griffin and J.R. Hauser, A. Griffin and J.R. Hauser, "Integrating R&D and Marketing: A Review and Analysis of the Literature," *Journal of Product Innovation Management* 13, no. 3 (1996): 191–215;; G.J. Avlonitis, P.G. Papastahopoulou and S.P. Gounaris "An Empirically based Typology of Product Innovativeness for New Financial Services: Success and Failure Scenarios," *Journal of Product Innovation Management* 18, no. 5 (2001): 324–342.

<sup>34</sup> W.E. Souder, *Managing New Product Innovations* (New York: Lexington Books, 1987).

and a close fit between the firms' strategy and resources<sup>37</sup> have also been cited as contributing to the success of product development. Unfortunately, these studies of product development did not analyze or examine any single institution that is related to IBIs. The examination of IBIs will probably give a different insight on how they develop the products and services.

Meanwhile, early studies from an Islamic banking perspective focused more on establishing the institutions and providing basic products, such as saving, current and investment accounts for the customer. Siddiqi (1983) for example states that the focus at this phase was only the need to eliminate *ribā* by replacing it with profit-sharing *muḍārabah* of both sides in balance sheet; assets and liabilities. He asserts that the ideal product was to replace interest-based with profit-loss sharing contract.<sup>38</sup> However, his idea still remains a conceptual thought rather than an applied practical approach adopted by Islamic banks. The concept becomes less popular due to many problems encountered, such as moral hazard and asymmetric information.<sup>39</sup>

The practitioners gradually avoided profit-loss sharing's concept in Islamic banking operations and they started to find other alternative underlying principles that were feasible and efficient, as conventional banking. In this respect, Hamoud (1985) introduced *murābahah* as the alternative mode of financing to Islamic banks.<sup>40</sup> The idea to employ *murābahah* as an alternative to Islamic banking products was actually derived from his PhD dissertation. After graduation, he then worked with the Jordan Islamic Bank and introduced the concept to the bank. In addition, the Kuwait Finance House also adopted his idea. The essence of the concept was then applied by Dr. Abdul Halim Ismail (1990), the first manager of Bank Islam Malaysia Berhad (BIMB). Islam-

<sup>35</sup> A. Lievens and R.K. Moenaert, "Project Team Communication in Financial Service Innovation," *Journal of Management Studies* 37, no. 5 (2000): 733–766.

<sup>36</sup> X.M. Song and M.M. Montoya-Weiss "Critical Development Activities for Really New versus Incremental Products," *Journal of Product Innovation Management* 13, no. 2 (1998): 124–135; J. Tidd and K. Bodley, "The influence of Project Novelty on the New Product Development Process," *R&D Management* 32 (2002): 127–138.

<sup>37</sup> U. De Brentani "Innovative Versus Incremental New Business Services: Different Keys for Achieving Success," *Journal of Product Innovation Management* 18, no. 3 (2001): 169–187.

<sup>38</sup> Muḥammad Nejatullah Siddiqi, *Banking Without Interest* (Leicester: The Islamic Foundation, 1983); Mohammad Nejatullah Siddiqi, "Islamic Banking and Finance in Theory and Practice a Survey of State of the Art," *Islamic Economic Studies* 13, no. 2 (February 2006):1-48; Mohammad Hamidulah, *Introduction to Islam* (Kuwait: IIFSO, 1970), 49.

<sup>39</sup> Mohammad Nejatullah Siddiqi, *Issues in Islamic Banking: Selected Papers* (Leicester: The Islamic Foundation, 1983), 77-122.

<sup>40</sup> Sami Hamoud, *Islamic Banking: the Adaptation of Banking Practice to Conform with Islamic Law* (London: Graham and Trotman Ltd. 1985).

ic banks in Malaysia are not known to be profit-loss sharing based, instead they are more inclined towards trade-based modes of finance, in which *murābaḥah* becomes the applied contract since the establishment of the first bank in Malaysia. Consequently, *murābaḥah* has conquered the method of product development of Islamic banking, although it was neglected previously in the early phase.<sup>41</sup>

Notwithstanding, many other studies have been undertaken by scholars interested to investigate the phenomenon of Islamic banking, either Westerners or Muslim scholars. Ray (1995) for example discusses the modes of finance in Arab Islamic banking which covered various Sharī'ah contracts in detail.<sup>42</sup> Nevertheless, his study focused on *murābaḥah* type of contracts but not on the concept of product development *per se*. Vogel and Samuel (1998) have included a comprehensive chapter that addressed the subject of innovation in Islamic financial services. This chapter attempted to explain and clarify the concept and the theoretical framework of innovation in IBIs. Both authors have introduced many techniques and methods, such as parallel forward sale (*salam mawāzī*) and parallel commission sale (*istiṣnā' mawāzī*) although they are considered new to the Islamic banking. The chapter becomes a comprehensive like textbook that provides guidelines on Islamic finance in English language.<sup>43</sup> Nonetheless, although, the above studies can be regarded as the earliest studies which focused on product development in Islamic banking, however they have neglected many essential features in developing Islamic banking, such as risk management, and Sharī'ah governance system. These factors are important and may affect the approaches taken in developing Islamic banking products.<sup>44</sup>

Due to the importance of product development in Islamic banking, the later studies undertaken are more specific, rigorous and critical. Gainor (2000), for example, echoes that in order to make the product successful, the process of product development must involve Sharī'ah scholars, Islamic financial advisors, asset managers, custodians and registrars of administrative services, lawyers, directors, distributor/selling

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<sup>41</sup> Abdul Halim Ismail, "Sources and Uses of Funds: A Case Study of Bank Islam Malaysia Berhad," in *Developing a System of Financial Instruments* (Jeddah: Islamic Research and Training Institute, 1990), 193-205.

<sup>42</sup> Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (UK: Graham and Totham, 1995), 37-80.

<sup>43</sup> Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance, Religion, Risk and Return*, (London: Kluwer Law International, 1998)

<sup>44</sup> Zamir Iqbal, "Financial Engineering in Islamic Finance," *Thunderbird International Business Review* 41, no. 4-5 (July-October 1999): 541-59.

agents/marketing groups, customers and project coordinators to ensure that the product is Sharī'ah compliant.<sup>45</sup> However, his article lacks scientific methods, which did not propose any significant recommendations for product development in Islamic banking. Thomas, Cox and Kraty (2005) have compiled various articles, from different authors, mostly industry representatives. They attempted to provide the conceptual background and important issues in the product development, such as Islamic financial instruments, risk management, liquidity management, securitization and regulatory challenges in providing Islamic financial products.<sup>46</sup> Unfortunately, the book did not make any critical examination of the approaches practiced by Islamic banks and Sharī'ah issues faced by Islamic banks in developing product.

Recent studies on product development turn out to be more serious and advance, especially concerning the tools of product development. Iqbal (1999) proposes two approaches of product development that can be employed by IBIs namely “reverse financial engineering and financial innovation”. Arbouna (2007), for example, recommends that the combination of contracts may become a tool for developing new product in Islamic banking and finance.<sup>47</sup> However, the article only focuses on combination of contracts, without giving overview on the concept of product development in Islamic banking. Meanwhile al-Suwailem (2007) argued that in order to develop a sustainable product, there are four principles must be followed, namely, balance, integration, acceptability and consistency. Following these principles, three strategies can be implemented: imitation, mutation and satisfaction. His study only relates to the principles and theoretical approaches, but it does not address the practical matters of how to apply the principles practically in developing Islamic banking products.<sup>48</sup> Islamic Research and Training Institutions (IRTI) (2008) also published a comprehensive book concerning the financial products and instruments in the Islamic legal tradition, which may become a guideline for product developer. However, the shortcoming of the work is that it is only concerned with the classical contracts but neglected the contemporary re-

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<sup>45</sup> Thomas Gainor, “A Practical Approach to Product Development,” 1-13 (paper presented at the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead Cambridge, Massachusetts, Center for Middle Eastern Studies, Harvard University, September 30 – October 1, 2000)

<sup>46</sup> Abdulkader Thomas, Stella Cox and Kraty Bryan (editors), *Structuring Islamic Finance Transactions* (United Kingdom: Euromoney, 2005).

<sup>47</sup> Mohammad Arbouna, “The Combination of Contracts in Sharī'ah: A Possible Mechanism for Product Development in Islamic Banking and Finance,” *Thunderbird International Business Review* 49, no. 3 (May–June 2007), 341–369.

<sup>48</sup> Sami al-Suwailem, “Financial Engineering: An Islamic Perspective,” *Jurnal Kajian Bisnes dan Manajemen* 9, no. 1 (January 2007), 87-102.



quirements of product development.<sup>49</sup> Ahmed (2011) examined the phenomenon of product development in Islamic banking. In brief, his study focuses more on the features of financial products, phases of the product development cycle, strengths and weaknesses of product development system in Islamic banks and provides some suggestion for the future direction of the Islamic financial industry.<sup>50</sup> However, his study did not elaborate on the legal and regulatory challenges as well as the notion of *hiyal* that influence the concept and design of product development in Islamic banking.

Islamic banking's product development also highly focuses on the aspect of legality from the perspective of classical Sharī'ah scholars. This gives a little space for a new interpretation of the law. According to El-Gamal (2006), the concept of Sharī'ah arbitrage was used by Sharī'ah advisors to forbid some transactions, and then permit them in slightly modified forms, with unaltered substance.<sup>51</sup> In other words, it involves the process of modifying interest-bearing debt, collecting interest in the form of rent or price mark-up.<sup>52</sup> Furthermore, he claimed that financial regulators and law enforcement officials in the Islamic world lag significantly behind their Western counterpart in sophistication and understanding of structured finance. This will expose the banks to money laundering and criminal financiers, which are higher in Islamic finance than elsewhere. This is because such criminal financiers always seek the opportunity through the weakest link in regulation and law enforcement to make Sharī'ah arbitrage. Another consequence of this event is that this wrongdoing has tarnished the good image of Islamic finance.<sup>53</sup> However, the study failed to explore the concept of *hiyal* from various perspectives of *fiqh* school.

Product development of Islamic banking also faces legal and regulatory challenges. According to Mohd Yassin (2001), Islamic Banking Act enacted on 1983 in regulating Islamic banking operations was lagging behind despite the rapid develop-

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<sup>49</sup> Islamic Research and Training Institutions (IRTI), *al-Muntajāt wa al-Adawāt al-Māliyyah fī al-Fiqh al-Islāmī*, (Jeddah: Islamic Development Bank, 2008).

<sup>50</sup> Habib Ahmed, *Product Development in Islamic Banks* (Edinburgh: Edinburgh University Press, 2011).

<sup>51</sup> Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006), 148-149.

<sup>52</sup> Mahmoud A. El-Gamal, "Incoherence Pietism and Sharī'ah Arbitrage," accessed on 5 May 2013, <http://www.ft.com/cms/s/1/01ccc914-0553-11dc-b151-000b5df10621.html#ixzz2SK8uZ3Vd>; Mahmoud A. El-Gamal, "Mutuality as an Antidote to Rent-Seeking Shari'a-Arbitrage in Islamic Finance," *Thunderbird International Business Review* 49, no. 2 (March/April 2007): 187-202.

<sup>53</sup> El-Gamal, *Islamic Finance*, 24.

ment that has taken place in the Islamic banking industry.<sup>54</sup> Unfortunately, since the article was published, there are various advances and progresses happened in the industry, which are not addressed in her article. Furthermore, Engku Ali (2008) examined the legal problems faced by Islamic financial institutions in Malaysia including legal documentations of Islamic financial transactions are not reflected to the Sharī'ah requirements, the court applying different principles of law, the judges and lawyers were not trained in Sharī'ah, the refusal of the court to apply Sharī'ah, and a tendency of the court comparing Islamic financial transactions with conventional *ribā*-based transactions.<sup>55</sup> In addition, Ab. Halim, (2011) observed that the current legal system is still in the same pace, where no improvement has been made in the system.<sup>56</sup> However, both studies did not analyze the current developments in Islamic banking law, where the government has legislated two new acts; the Islamic Financial Services 2013 (thereafter IFSA 2013) and the CBMA 2009, and the on-going discussion about the extent to which the laws can support the development of Islamic banking products which still remain unanswered. In terms of the regulatory framework, Hasan (2011) has conducted a study on Sharī'ah governance system and found many inadequacies of the system in Malaysia. However, his study so far did not attempt to relate the impact of the findings to the process of product development in Islamic banking.<sup>57</sup>

The concept of *hiyal* and *makhārīj* (jurisprudential exits) has been discussed by many scholars. Rosman (2008) for example examined both concepts from the perspective of *fiqh*, where various opinions from the classical and contemporary scholars have been adopted.<sup>58</sup> However, the shortcoming of the study is it did not attempt to examine *hiyal* and legal and regulatory issues from the perspective of product development.

From the foregoing discussion, it is observed that the study of product development in Islamic banking has been given little attention despite its rapid growth since four decades ago. There are few research gaps left by the previous researches, which only focus on one theme and neglect the other themes. For example, Ahmed (2011) on-

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<sup>54</sup> Norhashimah Mohd Yasin, "Islamic Banking in Malaysia Legal Hiccups and Suggested Remedies," *IJUM Law Journal* 9, no. 1 (2001): 1-20.

<sup>55</sup> Engku Rabiah Adawiah Engku Ali, "Constraints and Opportunities in Harmonisation of Civil Law and Shariah in the Islamic Financial Services Industry" *Malayan Law Journal* (2008): i - xxxvii.

<sup>56</sup> Ab. Halim, "Enhancing the Effectiveness of Legal Infrastructure, 1-14.

<sup>57</sup> Zulkifli Hasan, "Sharī'ah Governance in Islamic Financial: Institutions in Malaysia, GCC Countries and The UK," (PhD diss., University of Durham, 2011).

<sup>58</sup> Arif Saleh Rosman, "*Hiyal wa Makhārīj al-Fiqhīyyah fī Mu'āmalāt al-Maṣrifīyyah al-Mu'āṣarah: Dirāsah Tahlīliyah Taṭbiqīyah li Tajrībah fī Bank Islam Malaysia*," (PhD diss., International Islamic University of Malaysia, 2008).

ly emphasizes the process of product and he did not deeply analyze the impact of *hiyal* in product development. In contrast to Rosman (2008) only studied the aspect of *hiyal* but ignored the process of product development in Islamic banking. Therefore, this study attempts to consolidate the research gaps left by both authors.

Although some of the previous studies have extensively examined the conceptual framework of product development, none of the studies attempted to relate it to the context of Malaysian Islamic banking practices. In other words, previous studies only attempted to provide a general overview of product development's approaches taken in Islamic banks, without specifically studying a specific context of a country, which has different situation and perspective in developing its Islamic banking industry. For example, El-Gamal (2006) focused on the practice of Islamic finance in US, where it has different legislation, which is incompatible with the Shari'ah principles. Although Ahmed (2011) undertook samples from four Islamic banks in Malaysia, however, he did not justify why these Islamic banks were selected and his study attempted to generalize the approaches taken by most Islamic banks and his study neglected the context of the Islamic banks, which is different from one country to another country. This study argues that such method is not appropriate because each case study has rich and contextualized situation, which must be taken into consideration, the legal framework regulated the Islamic banks and the local Muslim jurists' opinions on Islamic commercial laws.

By taking Malaysian Islamic banks, as a focus, this study will argue that the approaches taken in developing Islamic banking products by this country are unique, robust and different from other countries that offer Islamic banking products. In order to clarify the focus of the uniqueness, robustness, and differences in the approach, this study focuses on three aspects. Firstly, the study delves deeply to examine the theoretical approach of product development in Islamic banking. Secondly, since previous studies also paid little attention to legal and regulatory challenges, especially with regard to the IFSA 2013, which was enacted recently by the BNM to monitor the industry, this study will thoroughly investigate the impact of the law to the process of Islamic banking's product development. Finally, this study will provide extensive outlook on the issues of *hiyal*, the understanding of Muslim jurists generally and Shari'ah scholars in Malaysia particularly. By examining these elements, the study will attempt to describe the nature of product development's approaches undertaken by the Malaysian Islamic banks.

## 8. Outline

Chapter 1 introduces the criteria of the Islamicity of Islamic banking products. It attempts to clarify the concept of Sharī'ah in Islamic banking, the prohibition of *ribā* and *gharar*, as well as the concept of Islamic economics and economic morality that becomes the underpinning precepts of Islamic banking. Furthermore, it will explain the theoretical models that are currently discussed in academic discourses. Finally, the chapter discusses the overview of types of Sharī'ah contracts and Islamic banking products.

Chapter 2 examines the proposition of product development from the conventional and Sharī'ah perspectives. It also will discuss the general precepts governing the product development as well as the Sharī'ah framework for legalizing Islamic banking products. Furthermore, some approaches taken by Islamic banks to structure product also will be elaborated and finally, this is followed by a discussion of the process of Sharī'ah approval.

Chapter 3 discusses the legal and regulatory challenges faced by Islamic banking institutions in developing Islamic banking products. This chapter will present an overview of the Malaysian legal framework and laws associated with Islamic banking. Few issues regarding the legal system will be discussed to shed some light on the issues of legal framework in governing Islamic banking operations. As part of the regulatory framework, the role of Sharī'ah Advisory Council, which is part of the Sharī'ah governance system, will be explained. This chapter will also bring in some issues regarding the Sharī'ah governance system as implemented in Malaysia. The problem of legal jurisdiction to adjudicate the cases of Islamic banking will also be elaborated. Besides, two legal risks, Sharī'ah and legal risk will also be discussed as they are important in the legal and regulatory framework. As these risks are derived mostly from the process of legal documentation, this chapter allocates a detailed discussion on how to draft a good legal document that complies with both Sharī'ah and national law of Malaysia.

Chapter 4 analyzes the issues of *hiyal* in Sharī'ah and Islamic banking. This chapter will expound the proposition of *hiyal* among Muslim jurists and their arguments on the position of *hiyal* in Sharī'ah. Detailed discussion will focus on the aspect of definition of *hiyal*. The discussion also highlights whether *hiyal* can be regarded, as a method to circumvent Sharī'ah prohibitions or a method of jurisprudential exits. As intention

is a very important component that determines the position of *hiyal*; moral or immoral, the aspect will also be explained in a great detail. This is followed with a discussion on how to locate *hiyal* in Islamic commercial transactions. The parameter of *hiyal* will be presented, as part of discussion in order to regulate the use of the method in Sharī'ah and Islamic banking. Finally, the chapter explains two contracts, which have been linked to *hiyal*, namely *bay' al-ṭinah* (double sale/sale and repurchase) and *tawarrūq* (tripartite sale).

Chapter 5 scrutinizes some products developed in Malaysian Islamic banks. This is the last chapter that will show how Islamic banks in Malaysia develop their products. Three Islamic banks, namely Maybank Islamic, Bank Rakyat and Kuwait Finance House with three products - Islamic credit card, Islamic mortgage and Islamic house financing – have been chosen as case studies. A thorough analysis is made on the structure employed. This chapter aims to address how Islamic banks in Malaysia structure their products and the discussions include the *modus operandi*, Sharī'ah rulings of the contracts and contentious issues about the products.

Finally, chapter 6 concludes the research and provides some recommendations to improve the product development in Malaysian Islamic banking. It also provides contributions, limitations, and avenues for future research.

## CHAPTER 1: ISLAMICITY OF ISLAMIC BANKING PRODUCTS

### 1.1. Introduction

*“Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy” (Umer Chapra, 1982)<sup>59</sup>*

Islamic banking is not only about an interest-free banking that offers the basic banking needs to customers, but it is also an institution that attempts to distribute an equitable distribution of income and wealth and to encourage the economic participation in the economy among society.<sup>60</sup> Since, the goal of Islamic banks is beyond than that; hence it is very important to delve deeply on what kind of economic, legal and Sharī‘ah principles underlie the establishment of the bank and the process of product development adopted by Islamic banks. Therefore, this chapter aims to explore thoroughly the concept and determinants of “Islamicity” of Islamic banking products.<sup>61</sup> In this respect, this study will discuss two important parameters that determine the Islamicity of the products, namely Sharī‘ah and Islamic economic principles. Thereafter, this chapter will present two models of Islamic banking that are currently debated in the academic discourse. In the same time, the chapter draws some classification of Sharī‘ah contracts used in developing the products. Finally, this chapter will also address the controversial issues of *ribā* and *gharar* in Islamic banking activities.

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<sup>59</sup> M. Umer Chapra, “Money and Banking in an Islamic Economy,” in M. Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Jeddah: International Centre for Research in Islamic Economics, 1982), 145-186.

<sup>60</sup> Mohamed Ariff, “Islamic Banking,” *Asian-Pacific Economic Literature* 2, no. 2 (September 1988): 48-64.

<sup>61</sup> Many scholars have uttered the concept of Islamicity in their discourses. For example, al-Fārūqī (2012) coins it from the paradigm of *tawhīd*, where there is no God but Allāh and Muhammad is the Messenger of Allāh. How for the purpose of this research, the concept of Islamicity refers to the extent to which Islamic banking product complies with the objectives of Sharī‘ah and Islamic economic principles. See Ismā‘īl R. al-Fārūqī, *Islam: Religion, Practice, Culture & World Order* (Herndon: IIIT, 2012), 5; for the extensive benchmark to determine Islamicity of an economic system, see Scheherazade S. Rehman and Hossein Askari, “An Economic Islamicity Index,” *Global Economy Journal* 10, no. 3 (2010): 1-37.

## 1.2. What is Sharī‘ah?

### 1.2.1. Defining Sharī‘ah

Sharī‘ah literally means a way to the watering-place or path.<sup>62</sup> Technically, it is related to the corpus of Islamic law and some scholars denote it as a general concept that encapsulates the whole teaching of Islam, namely the Oneness of God (*tawhīd*), ethics (*akhlāq*) and law (*fiqh*). Generally, Sharī‘ah encompasses all aspects of human life, “from birth to death,” that integrates the element of social, politic, economic, and ethical values. This has been asserted by Kamali (2008) that Sharī‘ah is the right way of religion or the right path of Muslims, which is primarily more associated with a set of values that are essential to the Islamic religion.<sup>63</sup> Ibn Qayyim (d. 1350), a medieval scholar describes Sharī‘ah is “the dispensation of justice (*‘adl*) in interest of the servants of God in their earthly existence and the Hereafter. It is all about justice, mercy, benefit and wisdom. Every ruling, which is contrary with the justice, mercy, benefit and wisdom is not part of the Sharī‘ah, it is God’s justice, mercy, and patronage to His servants, creatures, territories, and veracity’s sign of the Prophet of His messages”.<sup>64</sup>

In Islam, the aspect of religion and law is interrelated. The religion is built on the set of five pillars, namely – the testimony that only Allāh is the God and Muḥammad is the Messenger of Allāh (*shahādah*), to performing the ritual worship of five daily prayers (*solāt*), to fasting in the Islamic month of Ramadan (*ṣawm*), to giving almsgiving (*zakāt*), and to performing the pilgrimage (*Ḥajj*) for those who capable to do that. Each component of these five pillars is an essential component of the Sharī‘ah, for example, the ritual worship (*solāt*) is classified as *‘ibādāt* (devotional matters) and almsgiving or religious tax is expounded in the section of *muā‘malat* (civil transactions). The function of law, as a subset of Sharī‘ah, is to regulate all of these religious matters so that they will be conducted in accordance to the principles delineated in the

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<sup>62</sup> Muḥammad Hashim Kamali, “Source, Nature and Objectives of Sharī‘ah,” *The Islamic Quarterly* 33 (1989): 215-234.

<sup>63</sup> Yusuf al-Qaradawī, *Islamic Law in the Modern World*, translated by al-Hadi A. Khalifa from his book, *Madkhal li-Dirāsāt al-Sharī‘ah al-Islāmīyah* (Riyadh: Wamy House International, 2000), 135-145; Kamali, *Principles of Islamic Jurisprudence*, 366-392.

<sup>64</sup> ‘Abd Allāh Muḥammad Ibn Abū Bakr Ibn Qayyim al-Jawzīyyah, *I‘lām al-Muwaqqi‘in ‘an Rabb al-‘ālamīn* (Bayrūt: Dār al-Kutub al-‘Ilmīyah, 1993), vol.4, 337; See also Jakob Stovgaard-Petersen, *Defining Islam for the Egyptian State Muftis and Fatwas of the Dār Al-Iftā* (Leiden, Brill, 1997), 77.

Sharī'ah.<sup>65</sup> Kamali (2008) contends that the attention given to the legalistic predisposition of the Sharī'ah by western scholars, such as Schacht (d. 1969), is unduly exaggerated. Their conception about Sharī'ah has deviated from the original meaning and nature of the term, which is restricted only to a legal connotation. Since it is related to the general connotation of Islam, therefore, it is not erroneous to call Islamic banking as "Sharī'ah compliant banking," because both terms produce similar implications.<sup>66</sup>

The interest of examining the notion of Sharī'ah is not only Muslim scholars, but also non-Muslim scholars. Schacht (1983) for example connotes that the term is related to sacred law or religious law of Islam.<sup>67</sup> In the same vein, Calder and Hooker (1997) contend that Sharī'ah is "a rule of law, or a system of laws, or the totality of the message of a particular Prophet of Muḥammad s.a.w."<sup>68</sup> Hallaq (2001) describes Sharī'ah as the religious Islamic law.<sup>69</sup> However, the understanding of the Western scholars of Sharī'ah that only regards it as law is too narrow in scope, since its nature and scope are wider than that, as contended by the Muslim jurists, which entail the ethical and moral norms, as well as the belief in God.<sup>70</sup>

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<sup>65</sup> Muḥammad Hashim Kamali, *Sharī'ah Law: An Introduction* (Oxford: Oneworld, 2008), 1-3, 10; See his further explanations, where he quotes many Qur'ānic verses and Sunnah Traditions related to the Sharī'ah. Yūsuf al-Qarḍāwī, *Madkhal li-Dirāsāt al-Sharī'ah al-Islāmīyah* (Bayrūt: Mu'assasah al-Risālah, 1993), 10;

<sup>66</sup> In Indonesia, Islamic banking is called as "Sharī'ah banking," in order to differentiate with Islamic banking, which bring more general term than Sharī'ah term. Bank Indonesia, "The Blueprint of Islamic Banking Development in Indonesia," accessed on 14 June 2013, [http://www.ruralfinance.org/fileadmin/templates/rflc/documents/Blue print \\_of\\_ Islamic pdf.pdf](http://www.ruralfinance.org/fileadmin/templates/rflc/documents/Blue print _of_ Islamic pdf.pdf).

<sup>67</sup> Norman Calder and M.B. Hooker, "Sharī'a" in *the Encyclopaedia of Islam*, edited by C. E. Bosworth, E. Van Donzel, W. P. Heinrichs and G. Lecomte (Leiden: Brill, 1997), vol. IX, 321-328.

<sup>68</sup> Joseph Schacht, *Introduction of Islamic Law* (Oxford: Clarendon, 1983), 50, 54.

<sup>69</sup> Hallaq seems has revised his understanding about Sharī'ah, where he suggests that westerners should treat Sharī'ah is different with the understanding of law in western perspective that includes the element of ethics in the structure of Sharī'ah. See Wael B. Hallaq, "Groundwork of the Moral Law: A New Look at the Qur'an and the Genesis of Sharī'a," *Islamic Law and Society*, 16 (2009): 239-279; See his previous on the presumption of the Sharī'ah, Wael B. Hallaq, *Origins and Evolution of Islamic Law* (Cambridge: Cambridge University Press, 2001), 1

<sup>70</sup> Western scholars also questioned the compatibility of Sharī'ah with the modernity. For example, Schacht (1964) and Coulson (1964) argue that Sharī'ah could not practically be applied as state law in a rapidly changing world. Hallaq (2004) argues that Sharī'ah in the classical form is no longer a tenable reality and it has met its demise nearly a century ago due to the admission of the hegemony and importation of western legislation into Islamic countries. Furthermore, he argues that the professional lawyers, who are supposed to uphold the Sharī'ah law, are entirely ignorant of Islamic law and who have left behind the law in favor of the western law. However, it is beyond the scope of this research to argue as to whether Sharī'ah or Islam is compatible with the modernity, where many studies have been done to argue such compatibility. For the criticisms of Sharī'ah, see Joseph Schacht, *An Introduction to Islamic Law* (Oxford: Clarendon Press, 1964), 53-54; Noel Coulson, *A History of Islamic Law* (Edinburgh: Edinburgh University Press, 1964) 132-134. Wael B. Hallaq, "Can the Sharī'ah be Restored?" in *Islamic Law and the Challenges of Modernity*, edited by Yvonne Y. Haddad and Barbara F. Stowasser (Walnut Creek: Altamira Press, 2004), 21-53. For the argument of Sharī'ah compatibility with the banking business, see Ahmed Al-Janahi and David Weir, "How Islamic Banks Deal With Problem Business Situations," *Continued on next page...*



### 1.2.2. Sharī'ah and *Fiqh*

Sharī'ah can be divided into three essential components that deal with the rules of faith (*al-ahkām al-itiqādiyyah*), which is belief of the Oneness of God, the rules of moral and ethics (*al-ahkām al-akhlāqiyyah*), and the rules of civil affairs (*al-ahkām al-mu'āmalāt*) generally cover economics, social and political matters. Under the rubric of economic affairs, the issues of banking and finance are discussed. *Al-ahkām al-mu'āmalāt* are also associated with the term "*fiqh*", which literally means understanding. Technically, it means the knowledge of personal rights and obligations derived from the sources of the Qur'ān and the Sunnah.<sup>71</sup> Sharī'ah is often associated and interchangeably used with *fiqh*, where sometimes, the former can be associated with the whole corpus of divine law derived from Allāh and the latter is laws deduced from the jurists' understanding of the valid sources of Islamic law, namely the Qur'ān and the Prophetic Traditions (*Sunnah*).

The rules of *fiqh* are developed into five scales of measurements; namely obligatory (*wajib*), recommended (*sunnat*), permissible (*mubah*), reprehensible (*makrūh*) and prohibited (*ḥarām*), which are also known as *al-ahkām al-khamsah* (five values of rules). It is seemingly wrong to describe that *fiqh*'s rules as being identical to the codes of law in the modern legal context, as the principles of *fiqh* do not only constitute the positive rules - prohibited or obligatory values (*wajīb* or *ḥarām*), instead it also encompasses ethical and moral values, namely neutral (*mubah*), reprehensible (*makrūh*) and recommended (*sunnat*) values. In modern legal context, the measurement of law only constitutes the obligatory and prohibited components.<sup>72</sup> *Fiqh*'s rules have been originally deduced from the understanding of the Qur'ān and the Sunnah, and sometimes from the rationale sources, such as customary social practice (*urf*), juristic preference (*istihsān*) and public interest (*maṣlahah*). Codes of law, on the other hand, stem solely

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tions: Islamic Banking As A Potential Model For Emerging Markets," *Thunderbird International Business Review* 47, no. 4 (July/August 2005): 429 – 445; Aznan Hasan, "The Compatibility of the Sharī'ah in Solving Modern Complex Commercial Practice: An Appraisal," 151-171 (Paper presented at the International Seminar on Islamic Thoughts Proceedings, Department of Theology and Philosophy, Faculty of Islamic Studies, Universiti Kebangsaan Malaysia 7-9 December 2004).

<sup>71</sup> International Sharī'ah Research Academy for Islamic Finance (ISRA), *Islamic Financial System: Principles and Operations* (Kuala Lumpur: ISRA, 2012), 150.

<sup>72</sup> The understanding of law, when it is articulated in the modern context is automatically referred to the law enacted and enforced by the state. However, in the context of *fiqh*, the rules articulated in the Muslim's treatises are regarded as the best interpretations made by the Muslim jurists regarding the God's intention derived from the valid sources of the Qur'ān and the prophetic Sunnah.

from the rationale and human reasoning, which are totally separated or independent from the religious values, although undeniably some of the codes are in line with the spirit and teaching of Sharī‘ah. Hence, the proposition to regard *fiqh*’s rules as similar to the notion of modern laws’ code does not stand, as argued by Hallaq (2009), because the conception of law as understood by Muslims is different.<sup>73</sup>

The conception of Sharī‘ah and *fiqh* has been debated by many scholars upon its relationship. Al-Qarḍāwī (1993) for example argues *fiqh* is part of Sharī‘ah and the difference between the two corpuses is only between a general and a specific meaning. Rules of Sharī‘ah comprise of two parts, firstly rules that are explicitly mentioned in the texts, the Qur’ān and the Sunnah. Secondly, rules that are deduced from the human understanding of various sources, as stated in the discipline of *fiqh* treatises.<sup>74</sup> Furthermore, Sharī‘ah rules that are deduced from the Qur’ān and the Sunnah are fixed, whereas *fiqh* rules inferred by jurists may change according to the time, places and circumstances. Although, they seem non-identical, nonetheless, it was argued by al-Qarḍāwī that *fiqh* is part of Sharī‘ah or interrelated, because *fiqh*’s rules are knowledge based on the revealed texts. Even though, Muslim jurists seem to use independent sources, nevertheless, their judgments and legal positions on the legal rulings formulated are often within the ambit of the revelation.<sup>75</sup>

Beside al-Qarḍāwī, there was other scholar debated over its affiliation. Kamali (2009) asserts that Sharī‘ah and *fiqh* are not identical by virtue of the former’s immutability, whereas the latter is changeable. He explains that Sharī‘ah is conveyed mainly through divine revelation (*wahy*) of the Qur’ān and the authentic Sunnah, whereas *fiqh*’s rules refer mainly to the *corpus juris* that is developed by the legal schools or *madhāhib* (sing. *madhhab*) in Islam, individual jurists and judgements deduced to very specific legal reasoning methods of *ijtihād* or through legal verdict (*fatwā*).<sup>76</sup> This is obviously contrary to the proposition of al-Qarḍāwī (1993) who argues that *fiqh* and Sharī‘ah should not be demarcated, as they are interrelated with each other. When the former and the latter are differentiated, it seems that *fiqh*’s rulings are distinct elements

<sup>73</sup> This is because generally Muslims include the law of ethics is part of their law, whereas the western’s conception of law attempts to separate between the moral and ethics with positive law. See Hallaq, “Groundwork of the Moral Law,” 239-279.

<sup>74</sup> Al-Qarḍāwī, *Madkhal li Dirāsah al-Sharī‘ah al-Islāmīyyah*, 7, 9, 21-23; see also ‘Alī al-Khafīf, *Aḥkām al-mu‘āmalāt al-Shar‘īyyah* (al-Qāhirah: Dār al-Fikr al-‘Arabī, 1996), 3-4.

<sup>75</sup> Al-Qarḍāwī, *Madkhal li Dirāsah al-Sharī‘ah al-Islāmīyyah*, 21-23.

<sup>76</sup> Kamali, *An Introduction to Sharī‘ah*, 3.

from the Sharī'ah, whereas most *fiqh*'s ruling are derived from the same sources of the Qur'ān and the Sunnah. The difference in perspective is probably triggered due to the fact that many of *fiqh*'s rulings are derived from the process of *ijtihād* (effort to search Sharī'ah legal ruling) exercised by *fuqahā* (Muslim jurists) which relies substantially on human reasoning and rationale methods, such as *qiyās* (analogical reasoning), *maṣlahah* (public interest), and *istiḥsān* (juristic preference). On the other hand, the rulings derived directly from the divine texts are only a minority, pertaining to personal matters, such as marriage and inheritance.

Most topics discussed in *fiqh* books are derived from the Qur'ān, and the Sunnah. Abū Zahrah (1958) maintains that the origin of every topic in *fiqh* in both sources.<sup>77</sup> The Qur'ān it asserts that it does not neglect anything pertaining to the guidance and direction of the mankind's life and that everything can be found in the sources if people attempted to contemplate the essential of its teaching.<sup>78</sup> Hasanuzzaman (1984) argues that the Sharī'ah comprises of two things; injunctions and rules. The first deals with the do's and don'ts, as prescribed in the Qur'ān and the Sunnah, while the second, are those set of principles, which Muslim jurists have derived from the first sources.<sup>79</sup> However, his definition is too narrow, since Sharī'ah also comprises of the ethical and faith values. Khan (2013) asserts that it is important to differentiate between the divine (i.e. Sharī'ah) and the human understanding (*fiqh*) of religious knowledge. The Sharī'ah consists of a small number of injunctions stated in the Qur'ān and the Sunnah that deals with the permissible and prohibited or rights and wrongs. However, these injunctions are few in number but are quite clear and unambiguous and all of these are divine, immutable and binding on Muslims, and cannot be disputed. Whatever that does not fall under this definition, will be treated as out of the domain of the Sharī'ah. It could be human interpretation of the Sharī'ah, but not the Sharī'ah *per se*. He furthermore argues that it is unfortunate circumstances that some Muslim economists while writing on Islamic economics have not maintained the differences, where they mix up the divine with the human interpretative elements. Consequently, a lot of human thought is treated as the Sharī'ah, although it is not and this will give inflexibility and rigidity in the body's content of Islamic economics, which is the building block

<sup>77</sup> Muḥammad Abū Zahra, *Uṣūl al-Fiqh* (al-Qāhirah: Dār al-Fiqh, 1958), 80.

<sup>78</sup> "We have neglected nothing in the book," Sural al-'An 'ām: 38.

<sup>79</sup> S.M. Hasanuzzaman, "Definition of Islamic Economics," *Journal for Research in Islamic Economics* 1, no. 2 (1984): 51-53.

of Islamic banking. This will create a methodological problem, for Islamic economics and indirectly for Islamic banking.<sup>80</sup>

In this respect, it can be established from the understanding of contemporary Muslim jurists that Sharī'ah is about law, rules, regulations, commands, obligations, guidance, principles, ideology, faith and behavior, which governs the human being in every aspect of an Islamic life in this world and hereafter. Generally, Sharī'ah is linked to the divine rules or laws given by Allāh and *fiqh* is the corpus of laws extracted by Muslim jurists from the primary revealed divine sources of Islam - the process of their extraction requires human reasoning and interpretation, and the application of specific methodology of Islamic legal theory (*uṣūl al-fiqh*). *Fiqh*, in this respect, is always connoted with the term of Islamic law, as understood in the Western thought, while Sharī'ah also can be associated with "Islamic law," but in a more general connotation.<sup>81</sup>

To disassociate Sharī'ah and *fiqh* rules is not relevant in this case, since they are interconnected. Such dissociation gives the impression that the abandonment of the *fiqh* rules is acceptable because the rules deduced are only a human interpretation of divine rules, which may be right or wrong, whereas Sharī'ah rules cannot be neglected since they are divine rules. However, they are unified because each topic in *fiqh* can be found in the sources of the Sharī'ah sources. Muslim jurists, as qualified individuals, merely expand its jurisdiction by exercising *ijtihād* to solve the problem confronted by the Muslim societies. Nowadays, it is observed that *fiqh* rules interpreted are using consensus views among the jurists in order to handle various issues. Furthermore, some Muslim countries have taken a strong initiative to codify Sharī'ah and *fiqh* rules as the state's law, such as in the Qatar, Kuwait, Egypt, Bahrain and Jordan.

The enforcement of *fiqh* rules in contemporary framework shall have cooperation from the government. In this respect, the government with the cooperation with Sharī'ah scholars (*fuqahā*) to codify *fiqh* rules, as statutes and acts, which are enforceable and valid in the court of law. The *fiqh* rules elected shall not in favor of certain act of contracting parties, partial, unfair, biased or unreasonable, instead to take into account the whole objectives of Sharī'ah. The right of legislation shall not be restricted to the *fuqahā*, but it can be extended and debated in the parliament, before the law is

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<sup>80</sup> Muḥammad Akram Khan, *What is wrong with Islamic Economics? Analysing the Present State and Future Agenda* (Cheltenham, UK, Northampton, MA, USA: Edward Elgar, 2013), 66-69.

<sup>81</sup> Ahchene Lahsasna, *Maqāṣid al-Sharī'ah in Islamic Finance* (Kuala Lumpur: IBFIM, 2013), 6.

adopted. It is also insufficient to issue *fatwā* (plural: *fatāwā*) or legal opinion made by *muftī*, since the nature of *fatwā* is not binding where its function is only to give a legal interpretation or alternative solution happened to the requester but to codify the *fatwā*, as a legal rule. The *fatwā* also can be challenged in the court of law, if the contracting parties involved observe that the *fatwā* is unfair to them. This is consistent to the objective of Sharī'ah that aim to uphold just and fair treatment in human activities. In addition, the judge to adjudicate Sharī'ah cases shall be trained, exposed and provided with the methodology of *uṣūl al-fiqh* and the branches of *fiqh* rules of different four *madhāhib*, so that when they adjudicate any cases involved, they will concern and aware of the methodology as well as different legal opinions among different *madhāhib*. This element is very important for the judges to adjudicate cases in accordance to the Sharī'ah and to maintain the consistency of the law. Furthermore, the value of *sunnat* (recommendation), neutral (*mubāḥ*) and *makrūh* (reprehensible) shall be separated from the law, since they could not be enforced and imposed in the legal system. All in all, this idea is consistent with the modern meaning of "law" defined as "the system of rules which a particular country or community recognizes as regulating the actions of its members and which it may enforce by the imposition of penalties".<sup>82</sup> However, the difference between the modern legal systems with the Sharī'ah legal system is that the former is based human constructions, whereas the latter is based on religious values and divine sanctions.

### 1.2.3. The objectives of Sharī'ah

The objectives of Sharī'ah (*maqāṣid al-Sharī'ah*) are also important concept for a standard measurement of developing Islamic banking industry to ensure the product developed is consistent with the general principles of Sharī'ah. The word of *maqāṣid* (sing. *maqṣid*) represents a meaning of purposes, objectives, principles, intents or goals.<sup>83</sup> *Maqāṣid* are the objectives, purposes, or wisdoms behind Islamic practical rulings deduced by Muslim jurists, while Sharī'ah is defined as following strictly the injunctions of Allāh or the way of Islam. Hence, *Maqāṣid al-Sharī'ah* represents "the ob-

<sup>82</sup> Oxford Dictionaries, "law," accessed on 1 20 January 2014, <http://www.oxforddictionaries.com/definition/english/law?q=law>.

<sup>83</sup> Jasser Auda, *Maqāṣid al-Sharī'ah as Philosophy of Islamic Law: A Systems Approach* (London: The International Institute of Islamic Thought, 2008), 2.

jectives or the rationale or the wisdom (*ḥikmah*) of the legal practical rulings of Sharī‘ah.”<sup>84</sup> It has been argued that the concept is capable of providing social justice, equitable distribution of income and wealth and promoting economic development and growth.<sup>85</sup> According to Ibn ‘Ashūr (2006), “the overall objective of Islamic legislation is to preserve the social order of the society and to insure its healthy progress by promoting the well-being and the virtue of the human being. The well-being of human beings consists of the soundness of their intellects and the righteousness of their deeds, as well as the goodness of the things of the world in which they live that is put at their disposal”.<sup>86</sup>

The concept of *Maqāṣid al-Sharī‘ah* can be classified into various categorizations.<sup>87</sup> For the sake of easy understanding, it could be divided into three classifications; essentials (*ḍarūriyyāt*), necessities (*ḥajjiyyāt*) and embellishments (*taḥsiniyyāt*). The essentials refer to the necessities that people depend on and which the whole society would be in total disaster, disorder and disruption, without them. They are normally classified into five values, namely the preservation of religion, life, intellectual, progeny, and property. However, a number of other lists have been introduced including the preservation of social welfare support, freedom of speech, human dignity, and human fraternity and others within the concept.<sup>88</sup> Meanwhile, the necessities refer to supporting the needs and the interests required in order to have a smooth and decent life. A life without the protection of these needs faces hardships and difficulties that may turn and affect social functions very badly. For example, the permission of *salam* contract, although the subject matter of the contract does not exist yet when the contract is concluded, however, it has been allowed due to its necessity for the society. Without this contract, items that require a long time to produce, such as agriculture products, may not be traded in a big volume. *Salam* becomes a risk management tool, since it provides

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<sup>84</sup> Dusuki and Bouheraoua, “The Framework of Maqāṣid al-Sharī‘ah,” 1-38

<sup>85</sup> Asyraf Wajdi Dusuki and Abdulazeem Abozaid, “A Critical Appraisal on the Challenges of Realizing Maqāṣid al-Sharī‘ah in Islamic Banking and Finance,” *IIUM Journal of Economics and Management* 15, no. 2 (2007) 143-165; Asyraf Wajdi Dusuki and Said Bouheraoua, “The Framework of Maqasid al-Sharī‘ah (Objectives of the *Sharī‘ah*) and Its Implications in Islamic Finance,” (ISRA Research Paper no. 22/2011, International *Sharī‘ah* Research Academy, 2011).

<sup>86</sup> Muḥammad Ṭāhir Ibn ‘Ashūr, *Treatise on Maqāṣid al-Sharī‘ah*, trans. and annotated by Muḥammad El-Ṭāhir El-Misāwī (London and Washington: International Institute of Islamic Thought, 2006) 87.

<sup>87</sup> It can be classified in accordance to generality and particularity or definitive, speculative and illusion or inner strength. This study chooses the classification of inner strength as it provide more clear structure and comprehensive. Product of Islamic banking may be classified in accordance to this systematic structure. See Lahsasna, *Maqāṣid al-Sharī‘ah*, 15-30.

<sup>88</sup> Ibid. 19

a future protection for the producer and buyer as the stated price will be fixed, as stated in the initial contract. Otherwise, the price will fluctuate and both parties could not mitigate the risk.<sup>89</sup> On the other hand, embellishments are defined as the interests that offer improvement and progress in the moral and spiritual aspects of the Muslim society. The disappearance of these elements may not affect the societal functions or may not interrupt daily life of the society.<sup>90</sup>

#### 1.2.4. Sharī'ah and Islamic banking

Islamic banking is a part of Islamic economic system that aims to introduce Islamic ethics and moral judgments into the economic activities. These two elements of ethics and morality are not only regarded as the guidance on how to do business in banking, but they also become part of the belief's system of Muslims, the embodiment of their submission to Allāh and a religious obligatory duty for Muslims. Islamic banking can be explained as a system that provides financial accommodations to its customers; Muslim or non-Muslims, based on Islamic values, that render equitable treatments, just transactions, and free from unlawful factors in Islam. It functions as conventional banking in providing many banking services to the shareholders and customers. Nonetheless, the primary feature that distinguishes Islamic bank is its prohibition on taking *ribā* and being involved in any *gharar* (uncertainty) transactions. Each profit realized must be based on the risk assumed by the contracting parties. If the bank engages in any commercial and trade transactions, it must assume all related risks of commercial transactions, such as market, liquidity and credit risk. Islamic banking system is also always associated with participatory and active cooperation between the bank and its customers.<sup>91</sup> All the above propositions are encompassed generally under the concept of Sharī'ah, which is regarded as the essence and foundation of Islamic banking.

Sharī'ah is essential and relevant to the Islamic banking system and product development, as it provides the religious basis for the system. It provides the rules and

<sup>89</sup> Ibid., 29; Dusuki and Bouheraoua, "The Framework of Maqāṣid al-Sharī'ah," 1-38; Umer Chapra, *The Islamic Vision of Development in the Light of the Maqāṣid al-Sharī'ah* (Jeddah: IRTI, n.d.), 1-59.

<sup>90</sup> Lahsasna, *Maqāṣid al-Sharī'ah*, 30

<sup>91</sup> Reza Djojosedjito, "Mitigating Legal risk in Islamic Banking Operations," *Humanomics* 24, no. 2 (2008): 110-121; Yusuf Talal DeLorenzo, "Sharī'ah Supervision of Islamic Mutual Funds," 67-75 (paper presented at the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead Cambridge, Massachusetts, Center for Middle Eastern Studies, Harvard University. September 30 – October 1, 2000).

principles that should be abided, such as the Sharī'ah contracts that should be used, types of business that can be engaged by Islamic banks. The Sharī'ah framework regulates the operations and the products of Islamic banking so that they do not deviate from the original purposes of its divine objectives. As it has been established that *fiqh*'s rules are human extraction and interpretation of the Divine clear immutable laws found in the Qur'ān and the Sunnah and that some scholars, regard them as a significant aspect of the Sharī'ah, thus there are instances where *fiqh*'s rules have been institutionalized. In the wake of the Islamic banking industry, the rules of *fiqh* have been institutionalized. A specific institution or board, known as Sharī'ah Supervisory Council (SSB) or Sharī'ah Advisory Council (SAC) in Malaysia has been tasked to interpret the Sharī'ah. In addition to its task of interpretation, another primary responsibility of this board is to elaborate and distribute its resolutions (*fatāwā*) of rulings pertaining to the operations of Islamic banking. To ensure that the operations and processes as well as product development of Islamic banking are in tandem with the Sharī'ah principles by reviewing annually the operations of Islamic banks, the members of the board are selected experts in the disciplines of Sharī'ah, economics and finance. Their resolutions are regarded as the universal agreement in the process of harmonizing the conflict of opinions in the Sharī'ah. Hence, the negligence of *fiqh* rules, as interpreted by this authorized body, is regarded as the negligence of the Sharī'ah.

In this regard, Sharī'ah in this study refers to Islamic legal rulings deduced by SACBNM. In addition, this study also relies on the opinions issued by the International Sharī'ah standard's setting, such as the AAOIFI and the Islamic *Fiqh* Academy, based in Jeddah to issue Islamic legal rulings. Sometimes a different opinion from the SAC's decision is proposed to provide some suggestions or critiques from different point of views and to improve the legal decision made by the SAC. Furthermore, the interpretations of Sharī'ah made by different *madhāhib*, such as the Ḥanafīs, Mālikīs, Shāfi'īs and Ḥanbalīs, are also considered as part of Sharī'ah legal ruling. Nevertheless, the discussions of different opinions of *madhāhib* about Sharī'ah are offered to give a broad and pragmatic idea or solution to certain issues involved in Islamic commercial transactions.



### 1.3. The Concept of Islamic Economics

The values and the principles of Islamic economics are regarded as the skeleton of and the basis for Islamic banking's activities and operations. The end objective of Islamic economics generally is to seek justice and fairness in economic transactions. Islamic economics, as defined by Chapra (1996), is a branch of knowledge that helps realize human well-being through the allocation and the distribution of scarce resources in a manner that is in conformity with the Islamic teachings without unduly curbing individual freedoms or creating continued macroeconomic and ecological imbalances.<sup>92</sup> It is the knowledge and application of the injunctions and rules of the Sharī'ah, which prevented injustice practices in the acquisition and disposal of material resources, in order to provide satisfaction to human beings and to enable them to perform their obligations to Allāh and to the society.<sup>93</sup> Islamic economic is also regarded as a part of social sciences that studies the economic challenges of a people that is imbued with the values of Islam.<sup>94</sup> It attempts to outline a systematic effort to understand the economic problems and man's behaviour in relation to these problems from an Islamic perspective, which is aided by the foundational texts of the Qur'ān and the Sunnah as well as by reason and experience.<sup>95</sup>

The concerns of Islamic economics are not restricted to the prohibition of *ribā*, *gharar* or *maysir* (gambling) but are also extended to a widened scope of ensuring social justice and fair distribution of wealth to individuals and societies as a whole.<sup>96</sup> The establishment of Islamic banking in an Islamic economy is regarded as the restoration of social justice and fairness in economic dealings. Theoretically, Islamic banking is considered as a breakthrough of new paradigmatic intellectual framework that attempts

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<sup>92</sup> M. Umer Chapra, *What is Islamic Economics*, 35 (lecture given at IDB Prize Winners' Lecture Series, no.9, Islamic Development Bank, Jedda, 1996); Mohamed Aslam Mohamed Haneef, "Islam, The Islamic Worldview, and Islamic Economics," *IIUM Journal of Economics and Management* 5, no. 1 (1997): 39-65; see also Siddiqi, *Islamic Banking and Finance*, 1-48.

<sup>93</sup> Hasanuzzaman, "Definition of Islamic Economics, 51-53.

<sup>94</sup> M. A Mannan, *Islamic Economics: Theory and Practice* (Cambridge: The Islamic Academy, 1986), 18

<sup>95</sup> Khurshid Ahmad, "Nature and Significance of Islamic Economics," in *Lectures on Islamic Economics* edited by Ausaf Ahmad and Kazim Raza Awan (papers presented at International Seminar on Teaching Islamic Economics for University Teachers, Jeddah Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank (Ed.) IRTI, 1992), 19-48; M.Nejatullah Siddiqi, "History of Islamic Economic Thought," in *Lectures on Islamic Economics*, edited by Ausaf Ahmad and Kazim Raza Awan, Jeddah Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank (Ed.) IRTI, 1992), 69.

<sup>96</sup> Mehmet Asutay, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of *Homoislamicus* by *Homoeconomicus*," *IIUM Journal of Economics and Management* 15, no. 2, (2007): 167-195.

to consolidate finance, economy, community and society in a single system to produce economic efficiency and social justice. This is different from the financial, economic and social framework of the capitalist system, which attempts to seek self-interest, profit-maximization and materialistic achievement. The system fails to consider the needs of the society, moral, ethical and spiritual aspirations.

Islamic economics in this respect is an approach to interpret and solve man's economic problems based on the values, norms, laws and institutions found in and derived from all sources of knowledge in Islam, which leads to achieve the efficacious realization in this world and Hereafter.<sup>97</sup> The central position of its teaching is based on the revelation (*wahy*), i.e. the Qur'ān and the Sunnah, as well as rational thinking to solve the economic problem not only for Muslim but also mankind. The challenging task for the Islamic economists is to elaborate and use this revelation as well as reason and observation to develop the framework, characteristics, and values of Islamic economics suitable to reality. The Qur'ān and the Sunnah only provide general guidelines to guide mankind in their economic life. This manner entails a process of deriving answers based on the sources and as agreed by scholars, most of the economic applications will have to be derived, and is hence an intellectual effort.<sup>98</sup>

The main objectives of Islamic economics are unifying the spirit of brotherhood among people and utilizing the resources at their disposal entrusted to them from God, with an efficient, optimal, and equitable system.<sup>99</sup> These resources must be utilized to satisfy the needs and wants of people aimed at reducing the inequalities of income and wealth without generating inflationary pressures or causing sustained damage to the environment. Nonetheless, all or nearly all societies will seek the same economic reasons but they may differ in terms of economic priorities and appropriate strategies to achieve them. The focal point of Islamic economic system is to place justice and fairness in any economic activity, where the role of moral and ethical values is taken into consideration in realizing these goals. This notion however has been neglected in conventional economic analysis. Islamic economics does not totally reject all the notions of conventional economics, such as the market's mechanism, the concept of macro and microeconomics, allocating economic resources efficiently, scarcity, productivity, and

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<sup>97</sup> Mohamed Haneef, "Islam, The Islamic Worldview, and Islamic Economics," 39-65

<sup>98</sup> Ibid.

<sup>99</sup> Umer Chapra, review of *Islam and Mammon: The Economic Predicaments of Islamism*, by Timur Kuran, *Journal of Islamic Studies* 16, no. 2 (May 2005): 232-239.

incentives.<sup>100</sup> The Islamic economics' objectives is to add some extra values based on Islamic religious values by suggesting that the role of morality can help to improve the overall efficiency of the market.

The market mechanism as practiced in the contemporary time is unable to deliver justice to the society. According to Chapra (2005), the market cannot itself deliver justice and welfare to people, without an ethical dimension and the intervention of state to control the market, which circuitously attempts to reject the assumption of Adam Smith (1776). Smith claimed that if everyone pursued his self-interest, the 'invisible hand' of market forces would through the restraints imposed by competition; promote the interest of the whole society.<sup>101</sup> Although the state's role in this respect is obviously important, but this does not mean the state should be responsible to every single matter related to economic activities that occurs within its sovereignty. To reduce the burden of preserving the welfare to the people, the state must promote and honour the role of families and private ownership, respectively, which becomes the people's responsibility to take off. Chapra (2005) further establishes that based on good historical reasons, a morally-oriented individual, social and institutional reform, along with *zakah* (alms-giving) and *waqaf* (endowment) and other charitable contributions can play an important role in reducing poverty and disparity in wealth's distribution.<sup>102</sup>

Meanwhile, the concept of Islamic economics is also associated with the concept of Islamic moral economy. The latter concept is an attempt to amalgamate the needs for modern economic achievements with the spiritual dimensions of the Islamic values. Trip (2006) explains that the philosophy behind the principles of Islamic moral economy is an effort to moderate the behaviour of individuals, who would otherwise behave in the self-centred and calculating way depicted in the possessive individual of capitalist economics.<sup>103</sup> Asutay (2011) opines that the essential elements of Islamic moral economy can be shown in a diagram of vertical and horizontal axis. In the vertical axis, it focuses on the ethical equality of individuals in their relationship with God.

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<sup>100</sup> See for example, 51 keys of economic concepts common to study the principles of economics. Library of Economics and Liberty, "The 51 Key Economics Concepts," accessed on 31 December 2013, <http://www.econlib.org/library/Topics/HighSchool/KeyConcepts.html>.

<sup>101</sup> Adam Smith, *An Inquiry into the Nature and the Causes of the Wealth of Nations* (New York: The Modern Library, 1937), 423, as quoted from Umer Chapra, "What is Islamic Economics," 12 (lecture given at IDB Prize Winners' Lecture Series, no.9, Islamic Development Bank, Jedda, 1996)

<sup>102</sup> Ibid., Chapra, review of *Islam and Mammon*, 232-239.

<sup>103</sup> Charles Tripp, *Islam and the Moral Economy the Challenge of Capitalism* (Cambridge: Cambridge University Press, 2006), 124; see also Shafiel A. Karim, *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments* (Florida: BrownWalker Press, 2010), 1-2.

As a believer, he must believe that only one God, i.e. Allāh should be worshipped and He is the Omnipotent and Superior God that has created human beings. On the horizontal axis, as servant to God, human beings have equal opportunity to enjoy the bounties of God, social justice and beneficence between individuals and these concepts are encompassed in the *tawhīdic* (the concept that all of human beings beneath under one God, i.e. Allāh) framework.<sup>104</sup>

In this respect, it is observed that the difference between the two terms is only on general and specific meaning. The concept of Islamic economics is more associated with the general objectives, whereas Islamic moral economy refers to specific objectives on the purposes of Islamic economy that require to be achieved. In other words, Islamic economy is the ends, whereas Islamic moral economy is the means. For example, if the end objective of Islamic economic is to seek justice and fairness in economic transactions. Therefore, the aim of Islamic moral economy is to conduct and regulate the behavior of individuals that seek the economic transactions based on Islamic morality and ethics.

The concept of Islamic economics can be examined from the vertical and horizontal axioms of Islamic moral economy. According to Asutay (2011), the concept will integrate the development of the individual, society and state within the spirit of *tazkiyah* (purity) aimed to overcome the conflict between individuals and society. The ultimate consequence of the above functional axioms is that it will enable each element; individual, organization, society and state to achieve the state of victory (*falah*) in this world and hereafter within the *tawhīdic* framework, which believes that God has chosen a path for everyone and everything. This is known that only God created everything in this world. To prevent the conflict between the individuals and society, it is presumed that voluntary or charitable deeds are not enough, therefore some socially oriented financial and economic duties must be made mandatory or *farḍ* on the individuals

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<sup>104</sup> The concept of *tawhid* implies that Allāh is the owner of resources which are given to mankind in trust. In fulfilling the role of trustee, humans act as vicegerents (*khalifah*) of God on earth. These notions have implications for property rights and the nature of economic transactions that can be undertaken. All humans are created equal and given freewill by the Creator. An important inference of equality is the concept of justice, which forms one of the hallmarks of Islamic teachings. *Tawhid* also implies that Allāh is the source of knowledge and value. As such, all discussions on law and morality ensue from this concept. Mohammad Hashim Kamali, *Sharī'ah Law: An Introduction* (Oxford: Oneworld Publications, 2008), 17; Mehmet Asutay "Conceptualising and Locating the Social Failure of Islamic Finance Aspirations of Islamic Moral Economy vs. the Realities of Islamic Finance," *Asian and African Area Studies* 11, no. 2 (2012): 93-113; see also Zubair Hasan, "Islamic Banking at the Crossroads: Theory versus Practice," in *Islamic Perspectives on Wealth Creation*, edited by M. Iqbal and R. Wilson (Edinburgh: Edinburgh University Press, 2005), 11-25.

and society, such as benevolent loans. To realise this purpose, individuals are expected to know that they are the vicegerent of God, i.e. *khalifah* that is entrusted by God to administer the resources on the earth and to fulfil socially their responsibilities and duties towards the prospering of the world within the *tawhīdic* approach and moral filter.<sup>105</sup> Essentially, the term, “moral” in Islamic moral economy is just for the sake of terminology, since the term “Islamic” is sufficient to indicate all aspect of life, which consists of *tawhīd* (the Oneness of God), *fiqh* (law), and *akhlāq* (ethics). The main important element of this supposition is how to apply the proposition in the economic activities.<sup>106</sup>

Nonetheless, the concept of Islamic economics is also has been criticized by scholars. For example, Ramadan (2009) argued that there is no “Islamic economy” but “Islamic ethics” of economy to regulate economic activity. The norms and the goals orient and limit the use of the knowledge acquired.<sup>107</sup> Within the framework of Islamic ethics, it will control and regulate economic activities based on the principles of Shari‘ah, which is avoiding *ribā*, *gharar*, *maysir*, exploitation, and injustice. By giving, the label “Islamic economy” to a set of conventional techniques based on two or three principles is totally out of touch with the framework of ethics and the general principles of Islamic teachings on the subject.<sup>108</sup> Thus, one manages to propose formal and technical adjustments without questioning the higher goals of economic activity. He further adds that the perversion of Islamic economy and Islamic finance, which proposes a series of reforms of the techniques and modalities of transactions at the heart of the classical system, is dangerous. This is because they do not question the essence of the classical system that is to be applied in business. If they present the Islamic economy this

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<sup>105</sup> Ibid.

<sup>106</sup> Mohamed Aslam Haneef and Hafas Furqani. “Methodology: A Fundamental Missing Dimension in 30 Years of Research in Islamic Economics,” (paper presented at International Conference on Islamic Economics and the Economies of the OIC Countries organized by IRTI-IDB and Department of Economics, IIUM, Istana Hotel, 28 -29 April 2009; Mohammed Aslam Haneef “Can There Be an Economics Based on Religion? The Case of Islamic Economics,” *Post-Autistic Economics Review*, 34 (October, 2005), accessed on 11 May 2013, <http://www.paecon.net/PAERreview/issue34/Haneef34.htm>; Mohamed Haneef, “Islam, The Islamic Worldview, and Islamic Economics,” 39-65.

<sup>107</sup> Tariq Ramadan, *Radical Reform: Islamic Ethics and Liberation* (Oxford, New York: Oxford University Press, 2009) 128,

<sup>108</sup> Islamic ethics aims to control the economic activities from his perspective is not only an intellectual exercise in establishing a general orientation or setting out norms about the possibilities or limits of human actions, but also on the way in which the Islamic tradition has thought out utilizing Qur’ānic sciences, *ḥadīth* sciences, *fiqh*, and context sciences, exact, experimental, human sciences, its relationship to the texts and to universe, about philosophy of the sciences deduced from that relationship and about the meaning to be given to human action in history. Ibid., 134.

way, it is probably far from being an alternative or at least “a marginal option,” whose function is to confirm insensibly the pre-eminence of the mainstream liberal market economy.<sup>109</sup> In other words, Muslims should not have very distinct Islamic economic vocabularies or system, but only to have Islamic ethics to regulate the economic activities based on Islamic religious values. He seems to urge Muslims to accept the conventional economic system; its philosophy, epistemology, axiology, ontology and methodology, in its own right, and to regulate the system, methods, processes, and uses the notion of Islamic ethics prescribed in the texts and elaborated by Muslim scholars to screening the all aspect of conventional economics.<sup>110</sup>

#### **1.4. Siddiqi and Ismail’s Model of Islamic Banking**

Islamic banking system has its own philosophy, which underlies in a set of specific principles, namely Sharī‘ah and Islamic economic principles. Nonetheless, it is seemed that scholars do not agree with the principles, since they have different scholars about the principles that should Islamic banking acquires in running its operation. In this respect, the study selects two models of Islamic banks for examination. Firstly, a model that was introduced by Dr. Muḥammad Nejatullah Siddiqi (1983), where his main idea is that profit and loss sharing (PLS) should become the ideal conceptual model for Islamic banks. This model encourages risk sharing between the clients and the banks in commercial transactions. His model is the famous and ideal model for Islamic bank that has been discussed rigorously by academicians and practitioners, who seem to have a consensus that it is the ideal concept for Islamic banks. Siddiqi’s model will be compared with another model that was proposed by Dr. Abdul Halim Ismail, the first managing director of BIMB and presently a member of the SACBNM (2008-2013). He is regarded as the “Father of Islamic Banking in Malaysia”, where his model is based on the trading and debt financing framework.<sup>111</sup> The comparison between the two models will enable for us to identify the advantages and disadvantages of each

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<sup>109</sup> Ibid., 243.

<sup>110</sup> See also the criticism by Nienhaus on the aspect of Islamic economics. Volker Nienhaus, “Islamic Finance Ethics and Sharī‘ah Law in the Aftermath of the Crisis Concept and Practice of Sharī‘ah Compliant Finance,” *Ethical Perspective* 18, no.4 (2011):591-623; Volker Nienhaus, “Back to Real Economy,” *Islamic Finance News*, accessed on 6 March 2012, [http://www.islamicfinanceasia.com/article.asp?nm\\_id=18843](http://www.islamicfinanceasia.com/article.asp?nm_id=18843).

<sup>111</sup> Ariff, “Islamic Banking,” 46-62.

model, and which model able to achieve the objectives of Sharī'ah and Islamic economic system, theoretically and practically.

#### 1.4.1. Siddiqi's Model

Siddiqi's model stresses that Islamic banking system operates the the principle of profit and loss sharing activities, as the foundation of Islamic bank's operations. *Muḍārabah* is among the principle that should be adopted by the system. It refers to joint-partnership between two or more parties, where one party provides capital and the other party provides skills and knowledge in running a business or enterprise. Whatever profit made from the business will be shared by both parties as agreed upon in the initial agreement. However, when a loss occurs, it will be borne by the capital owner and the entrepreneur would only loose his efforts and time devoted in having run the business.<sup>112</sup> Having neo-classical economic educational background, Siddiqi not only explains his theory purely based on economic and financial reality but combined it with Sharī'ah rules. He developed this model in the late 1960's, when he wrote a book, titled "*Banking without Interest*", which explains in detail the operation of Islamic banks without interest. He conceived that *muḍārabah* is the best concept that can serve the basis of Islamic banking and the interest of the society, since both parties share the risk. He recommends that the bank should participate actively in the operation of running the businesses in a practical sense and not as a financial intermediary or a middle party. By joining actively in the business activities, the return and yield of Islamic banks can be justified due to the involvement of the Islamic banks in risk taking.

Siddiqi's model was actually based on the classical model of *muḍārib yuḍārib* (two-tier *muḍārabah*). Briefly, it is a profit-loss sharing concept, where someone becomes a capital provider, giving money to another person/entrepreneur, to use the money or asset as capital to venture into a business prescribed by the capital provider. Both parties agree that when the venture is profitable, they will distribute the profit according to the agreed portion, for example  $\frac{1}{2}$ ,  $\frac{1}{3}$ ,  $\frac{1}{4}$ , or as stated in the contract. If the venture make a lost, then the burden will be assumed by the capital provider, except in

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<sup>112</sup> Baghat Baghat Khalil El-Sharif, "Law and Practice of Profit-Sharing in Islamic Banking with particular reference to *Muḍārabah* and *Murābahah*," (PhD diss., University of Exeter, 1990), 22.

the case of negligence or breach of contract, then the entrepreneur must bear it.<sup>113</sup> Meanwhile, the concept of *muḍārib yuḍārib* means the one who mobilizes funds, on a profit-sharing basis, extends these funds to another user of the fund on the same basis (see figure 2).<sup>114</sup>

From the proposed model above, Islamic banks have two different roles, one as *rabb al-mal* (capital provider) and at the same time as *muḍārib* (entrepreneur or agent) who holds responsibility in running and generating profit from the funds obtained. However, Islamic banks do not utilize the obtained funds for the purpose of setting up their own business but only to provide it to other entrepreneur who will use it to establish a new business or for working capital. If the profit materializes, then the second entrepreneur will share it with the bank as in the pre-agreed contract, while at the same time, the bank also will share it with their depositors or investors, also based on the pre-agreed ratio signed by them prior to entering into the business. However, if the business incurs a loss, the loss will be passed to the depositor, as the real capital provider.



Figure 2: Two-Tier Model of Islamic Banking Proposed by Siddiqi

Siddiqi (1983) suggests that the entrepreneur should produce a quarterly accounting report to the bank, while the bank, in turn, will report to the shareholders and depositors to ensure transparency and good governance,. From the report, both, i.e. shareholders and depositors, will be informed on what has been done by the entrepreneur with the funds invested. The report is crucial for them since they can make a decision based on the performance - whether to retain or withdraw the funds. This is allowed under the concept of *muḍārabah*.<sup>115</sup> He assumes that the issuance of quarterly reports does not mean that the depositors or the shareholders will demand their capital back at the end of each quarter. Instead, the depositors in *muḍārabah* accounts will see

<sup>113</sup> Abū al-Wālid Muḥammad Ibn Aḥmad Ibn Muḥammad Ibn Aḥmad al-Qurṭubī al-Andalusī Ibn Rushd, *a Translation of Bidāyah al-Mujtahid*, translated from Arabic by Imran Ahsan Khan Nyazee (Reading: Garnet Publishing Ltd, 1996), vol. 2, 236.

<sup>114</sup> Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 18.

<sup>115</sup> Muḥammad Nejatullah Siddiqi, *Banking Without Interest* (Leicester: The Islamic Foundation, 1983), 40-42.



this practice as a transparent management of the funds and encourage them to deposit more money for an undetermined period, and the bank will probably invest for several quarters. He also suggests the creation of a current account or loan account where depositors who open this type of account will benefit from the safety of the deposited money and the convenience of making daily business transactions such as to issue cheques and transfer of money. The bank will not charge for these facilities, however, the bank is authorized to invest the money, as long as it remains in the account. Any profit earned from the investment will go entirely to the bank and the depositors will have no share in it. If the investment suffers a loss, it must be borne by the bank while the capital deposit is guaranteed.<sup>116</sup>

The model seems not to provide a solution for the short-term loan (debt financing) problem, such as personal loan or working capital for a new set-up business.<sup>117</sup> In this respect, he then proposes that the bank may use substantial funds from the loan account to be advanced as the short-term financing on an interest-free basis.<sup>118</sup> This is provided for the entrepreneur who is in need of additional capital temporarily, which he expects to return with the income he anticipates from the sales of his products. Siddiqi (1983) opines that to ensure the loan is to be repaid; the bank is allowed to take collateral against the loan in case the borrower defaults in payment or in the case of bankruptcy. The collateral can be sold to recover the loan given. On the other hand, instead of becoming a profit oriented-business entity, Islamic banking also should offer interest free loans to fulfill its socio-economic responsibility.

It is obviously seen that the model is too theoretical and ideal.<sup>119</sup> Due to this, Siddiqi again revisited his idea that Islamic banks may act as a financial intermediary, as conventional banks do.<sup>120</sup> Accordingly, when the bank obtains the funds from the depositors/investors in the form of *muḍārabah*, it may use the funds for financing and investing by using various contracts. The main difference between the former and the latter is that the latter model does not require the bank to enter the real sector, but to

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<sup>116</sup> Ibid, 48.

<sup>117</sup> Stewart C. Myers and Nicholas S. Majluf, "Corporate financing and investment decisions when firms have information those investors do not have," *Journal of Financial Economics* 13, no. 2 (1984): 187–221.

<sup>118</sup> Siddiqi, *Banking Without Interest*, 57-58.

<sup>119</sup> These issues have been addressed by Nienhaus (1984). See further more Volker Nienhaus, review of *Banking without Interest* by Muḥammad Nejatullah Siddiqi, *Journal of Research in Islamic Economics* 1, no. 2 (1984):85-90.

<sup>120</sup> Muḥammad Nejatullah Siddiqi, "Islamic Bank, Concept, Precepts and Prospects," *Review of Islamic Economics* 9 (2000): 21–32.

provide financing to the customer who requires financing to buy assets or services. The customers will pay some installments of the price and obtain financing from the bank to pay the remaining outstanding amount to the companies. The bank in this case will deal only in debt financing modes, such as *murābahah*, *salam*, *istiṣnā'* or *ijārah*, where it can minimize the risks exposed, such as market and equity risks. Thus, two-tier *muḍārabah* is transformed into a three-tier *muḍārabah*. The first tier comprises of depositors who provide the funds and banks, the second tier involves the bank, which provides financing, and the final tier consists of specialized companies and entrepreneurs, who provide products and services.<sup>121</sup> The later proposed model by Siddiqi (2000, 2002) seems similar to the proposed structure by Ismail (1992), which will be described below.

#### 1.4.2. Ismail's Model

In contrast to Siddiqi's model, Ismail (1992) offers his idea based on the function of conventional financial intermediary. When the first Islamic bank was setup in Malaysia, at the initial phase, the committee appointed by the Malaysian government to setup the bank found that it was very difficult to find a model which is suited to the general inspiration of the government's policy. The government policy aspired that the new establishment of the bank must consolidate a solid economic framework within the objectives of Sharī'ah, based on the concept of Islamic economics.<sup>122</sup> He articulated that the priorities of Islamic banking are derived from the Islamic elements of *tawhīd* (Oneness of God), *akhlāq* (ethics) and Sharī'ah (law). He argued that Islamic banking and financial activities should be undertaken within the appropriate sector of Islamic economic system as envisaged by the Sharī'ah. He opined that the Islamic economic system not only provides benevolent loans (*al-qarḍ al-ḥasan*) and charity (*ṣadaqāh*) but it is a complete, progressive and dynamic economic system made up of systemati-

<sup>121</sup> Siddiqi, "Islamic Banks: Concepts, Precepts and Prospects, 21-35; Muḥammad Nejatullah Siddiqi, "Comparative Advantages of Islamic Banking and Finance," (paper presented at Harvard University Forum on Islamic Finance, 6 April 2002)

<sup>122</sup> Abdul Halim Ismail, "Bank Islam Malaysia Berhad: Principles and Operation," in *an Introduction to Islamic Finance* edited by Sheikh Ghazali Abod, Syed Omar Syed Agil and Aidit Ghazali, (Kuala Lumpur: Quill Publishers, 1992), 243-283;

cally regulated production activities, although it imposes a concurrent responsibility towards the social welfare of the community.<sup>123</sup>

The concept of Islamic economic system, as asserted by Ismail (1992) are classified into three sectors namely the *siyāsī* (public sector), *tijārī* (private sector) and *ijtimā'ī* (social welfare sector). Public sector is concerned with the maintenance of law and justice, the promulgation and implementation of economic policies, the management of properties under state ownership, and economic intervention as necessary. Private sector is related to the creation of wealth which would in turn generate economic activities through production, consumption and distribution. Meanwhile, the social welfare sector is concerned with providing social benefits and social security to the society by promoting charity and benevolent loans. Therefore, the subject of Islamic banks and financial activities, in this regard, are to be those which operate under private sector.<sup>124</sup>

Moreover, the emergence of financial and banking sectors is due to the human needs for specific banking, and financial facilities and services. The most pressing need of financial facility is to fund economic unit in carrying out economic activities. The economic unit can be funded by using its own fund or seek other's capital. If it is financed through other's capital, then there are two types of financing available, either equity or debt financing. The demand of either types of financing depends on genuine human needs and neither is prohibited by the *Sharī'ah*. The banking activities serve such purposes as can be seen in the structure of modern social needs for various financing activities. Islamic banking is seen as an institution that promotes the principles of *al-ta'āwūn* (cooperation), reciprocal assistance and co-operation among members of a society for a good cause and the avoidance of *al-iktināz* that is keeping one's funds idle and not in circulation for the general benefit of the society.<sup>125</sup>

According to Ismail (1992), there is no significant difference between the practice of equity-financing techniques in the conventional and Islamic banking. He asserts that Islamic economics system has a broader scope of its operations and its scope is not limited to the contract of *muḍārabah*. For him, it is not an issue for Islamic banks to use conventional techniques in Islamic banking operations. The most important thing is to rationalize these operations along the Islamic contracts of *mushārah* or

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<sup>123</sup> Ibid.

<sup>124</sup> Thani, *et. al.*, *Law and Practice of Islamic Banking and Finance*, 17-21.

<sup>125</sup> Ibid.

*muḍārabah*. For example, Islamic banks may establish a financial institution or a company specializing in equity financing such as venture capital company under the *mushārah* contract, then the companies could mobilize the funds to finance the *muḍārabah* enterprise and business either in the form of *muḍārabah* or *mushārah*. However, the establishment of a separate company based on *mushārah* or *muḍārabah* is not the main objective of Islamic banking although it may be part and parcel of the system. Ismail restricted the Sharī'ah framework used in the banking and financial system is to finance a personal desire (personal financing) and working capital of enterprise through debt-financing, which is similar to conventional banks.<sup>126</sup>

On the other hand, the operations of Islamic banks can be divided into two parts i.e. how it obtains its sources (funds) and the application of these funds. The bank obtains from various sources, either current, saving or general investment accounts. For the first two accounts, they operate under the concept of *wadī'ah* (safekeeping), while the third account is under *muḍārabah* or *mushārah*. Besides, there is another special investment account in which it is created for specific customers for the government sector or corporate customers. In terms of the usage of the funds, the bank will spread them into various activities such as financing or participating in projects or asset acquisition in various ways in accordance with the Sharī'ah principles such as *muḍārabah*, *mushārah*, *bay' bithaman al-ājil (BBA)*, *ijārah*, *bay' al-takjiri* (financial lease) and *qard al-ḥasan*. In the meantime, the bank also provides specific facilities or financing on short-term basis to enable trade or working capital for the customer. These facilities may be granted for the purpose of exporting or importing or purchasing of goods and machinery, acquisition and holding of stock and inventories, spares and replacement, raw materials and semi-finished goods. Among other Sharī'ah concepts that can serve the product are *wakālah* (agency), *murābahah* (mark-up sale), *mushārah* and *muḍārabah*. The bank may also provide other services as conventional banks do, such as remittance and transfers of money, sale and purchase of foreign currency, portfolio management as well as trustee and nominee company services. In addition to functioning as financial intermediary, Islamic banks may also be involved in the trading of commodity, currency and securities within the financial sector.<sup>127</sup>

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<sup>126</sup> Ibid.

<sup>127</sup> Ismail, "Bank Islam Malaysia Berhad," 243-283.

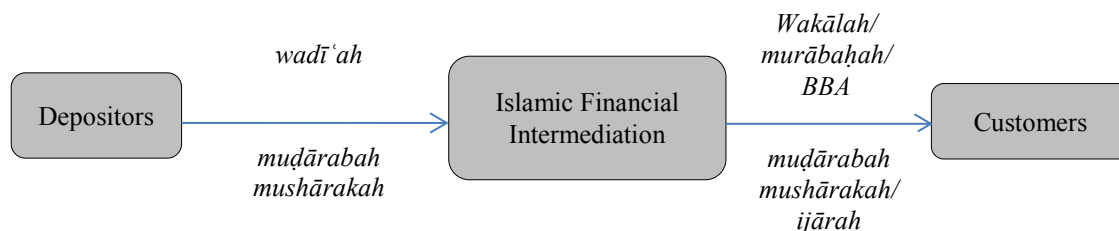


Figure 3: Islamic Bank as Islamic Financial Intermediation

In terms of recognition of revenues, the bank practices the cash basis accounting principle<sup>128</sup>, while for the income distribution methods, the bank may use sum of digits principle in which splitting between financing cost and profit distribution, on repayment sums received under *bay' bithaman al-ājil* and *ijārah*.<sup>129</sup> The bank also adopts the policy to maintain the general and specific provisions for the purpose of protecting all its deposits in current, saving and investment accounts. The bank may also decide to pay profits to relevant depositors based on the maturity of deposits funded in the bank. In calculation of profitability accounting, the bank calculates two levels of profitability which are: profitability for payment of its profits to the depositors, and to the bank. All the calculations are computed on a monthly basis.<sup>130</sup>

### 1.4.3. Analysis

There are some advantages and disadvantages of the two models proposed. Siddiqi's model stresses the Islamic banks should become active entrepreneurs and traders to do business in the real sector. His model has been well received in the academic world, as it encourages the cooperation and risk sharing between the bank and entrepreneur; however it has been argued that it is less practical in the real sense. One of its shortcomings is the model does not allow for debt financing in the Islamic economy, which is the pressing needs among people. One of his supporters, Khan (1997) has said that, "the Islamic economy becomes as a synonym for an all profit and loss sharing and a debt free economy. All debts in the economy would be caused by benevolent lending

<sup>128</sup> An accounting method in which income is recorded when cash is received, and expenses are recorded when cash is paid out. Paul D. Kimmel, Donald E. Kieso, Jerry J. Weygandt, *Financial Accounting: Tools for Business Decision Making* (US: Wiley, 2010), 166.

<sup>129</sup> In conventional accounting principles, it means method of computing interest-refund on a fixed installment loan (with add on interest) that is paid-off before its full duration (maturity). See more details in Carl S. Warren, James M. Reeve, Jonathan Duchac, *Financial and Managerial Accounting* (US: South Western Cengage Learning, 2009), 414.

<sup>130</sup> Ibid.

which is made on humanitarian and social grounds. This characterizes such debts as “non-economic,” although the debt itself may play an important financial role, particularly in alleviating the need of customers for credit”.<sup>131</sup> Moreover, not all the communities in the society are serious about taking the risks of venturing into a business that is uncertain of its gains, while in the case of interest-free loan, not all of them would volunteer to give their money for free without any compensation.

The Siddiqi’s model has been criticized due to its impractical nature in the current implementation of Islamic banking. This is different from the current model of financial intermediary that is based on the concept of lending business.<sup>132</sup> Siddiqi himself also has doubts over the permissibility of Islamic banks which operate under the two-tier *muḍārabah*.<sup>133</sup> He said, “It is not clear if the practice of two-tier *muḍārabah* reflected in these juristic discussions had evolved into pure financial intermediation, where one who obtained profit-sharing funds conducts the sole business of supplying these funds to other (working) parties on the basis of profit sharing”.<sup>134</sup> This idea was also contrary to some classical interpretation of Shāfi‘īs’ jurists who rejected the practice since they regard the middle party, i.e. the bank, as having made no significant contribution to the business activity.<sup>135</sup>

Besides, Siddiqi’s model would be beneficial if the discussions of the element of risk management of Islamic banks’ operations, regulatory framework and the human behavior towards the risky business are taken into consideration. In banking management, most prudent Islamic banks will avoid high risk investments and uncertain business ventures due to many potential problems such as moral hazard, agency problem, and adverse selection.<sup>136</sup> Furthermore, if the fund is kept under a saving account e.g. *wadī‘ah* or *amānah* (trusteeship) principle, then it will restrict their investment in high risk projects. Not all customers think to invest their money, perhaps they also need other services such as a payment service, to assist them to purchase asset, information provider about financial situation, and financier. These aspects are not covered in his

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<sup>131</sup> Khan, “An Analysis of Risk Sharing,” 23-24.

<sup>132</sup> Monzer Kahf, “Maqāṣid al-Sharī‘ah in the Prohibition of Riba and their Implications for Modern Islamic Finance,” (paper presented at IIUM International Conference on Maqāṣid al-Sharī‘ah, August 8-10, 2006)

<sup>133</sup> Tariqullah Khan, “An Analysis of Risk Sharing in Islamic Finance with Special Reference to Pakistan,” (PhD diss., University of Loughborough, 1996), 20.

<sup>134</sup> Ibid.

<sup>135</sup> Sharifuddin, “A Study on Muḍārabah,” 154.

<sup>136</sup> Humayon A. Dar, and John R. Presley, “Lack of Profit and Loss Sharing in Islamic Banking: Management and Control Imbalances,” *International Journal of Islamic Finance* 2, no. 2 (2000): 3-18.

model. In terms of the regulatory framework, regulators attempt to impose strict regulations and laws to monitor and supervise the *muḍārabah* activities to ensure the contracting parties' rights and obligations are safeguarded. Thus, some of the regulations, especially in Malaysia, imposed by the regulator are very strict in terms of capital adequacy ratios and risk management aspects as compared to secured products such as *murābahah* or *ijārah*.<sup>137</sup> This will hinder the bank from promoting *muḍārabah* as the underlying principle for the bank to develop a product, which is not discussed by Sidiqi.

In terms of human behavior and attitude towards investment which is uncertain of its gain and loss; majority of the customers attempt to avoid any risk taking and only few of them are inclined toward taking risks. This is rightly explained by Seif (2005), "each party is assumed to seek maximum expected utility in the sense of maximum possible income share at the minimum possible risk share. Recognition of risk as an undesirable fact of economic life, and that people would normally wish to throw it on others' shoulders".<sup>138</sup> The depositors or investors feel insecure if the bank uses their money for the investment that is very risky where its profit and returns are uncertain. This shows that not all of them volunteer to lose the money invested. For the purpose of retaining the customer, some of the banks need to creatively think of providing a mechanism that can guarantee money back, such as third party guarantee by the government or deposit insurance scheme, which is contrary to the nature of *muḍārabah* principles. Thus, the model does not provide good implications as thought by Sidiqqi (1983).

Meanwhile, Ismail's model (1992) is not much different from the functions of conventional banks as financial intermediation in terms of its sources, the application of the funds, type of services and accounting policies.<sup>139</sup> Islamic banking may operate under equity financing or *muḍārabah* but it is not the real objective of its establish-

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<sup>137</sup> Bank Negara Malaysia, "Guidelines on Mushārah and Mudharabah Contracts for Islamic Banking Institutions," accessed on 22 October 2011, [http://www.bnm.gov.my/guidelines/01\\_banking/04\\_prudential\\_stds/15\\_mnm.pdf](http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/15_mnm.pdf)

<sup>138</sup> S. I. Tag El-Din, "Income Ratio and the Risk-sharing Structure of Optimal Contracts: The break-even Theory of Muḍārabah," *Journal King Abdulaziz University: Islamic Economics* 21, no. 2 (2008): 37-59.

<sup>139</sup> The notion of Islamic banking model is also shared by other scholar, namely Mohd Daud Bakar (2002), Chairman of Sharī'ah Advisory Council of Bank Negara Malaysia. According to him, Islamic banks perform the function to transfers funds from saving surplus units to saving deficit units in the economy. Mohd Daud Bakar, "The Sharī'ah Supervisory Board and Issues of Sharī'a Rulings and Their Harmonization in Islamic Banking and Finance," in *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Ahmed Abdel Karim (London: Euromoney Books and AAOIFI, 2002), 74-89; Philip Molyneux, *Introduction to Banking* (England: Pearson Education Limited, 2006), 4.

ment, which is contrary to Siddiqi's proposed idea that suggests the use of *muḍārabah* as the chief principle in Islamic banking's operations. Ismail argues that the existence of Islamic banking is to meet customers' needs as has been done by other financial intermediaries in conventional banking. Hence, Islamic banks may use conventional concepts, either debt or equity financing or hybrid instruments suited to its objectives, as long as it's not contrary to the principles of the Sharī'ah. The increasing demand for funding to facilitate businesses supports debt financing, as the best means of operating Islamic banking businesses.<sup>140</sup> He totally accepts the idea that conventional banking be absorbed into the Islamic banking's operations, by the means of streamlining the latter's products through extracting the prohibited elements, which are contrary to the Sharī'ah principles and to place various nominated (*'uqūd musammā*) or innominated contracts (*'uqūd ghayr musammā*)- as the basis for Sharī'ah -compliant products.<sup>141</sup> The second approach adopted by him is that the Sharī'ah does not prevent any human activity except those explicitly stated in the two sources of the Qur'ān and the Sunnah. Thus, Islamic banks may carry any activity, which is not contrary to the Sharī'ah principles.

Ismail's model emphasizes the role of Islamic banking as financier to assist entrepreneurs, traders or individuals to expand their businesses. The bank does not involve in any trading or enterprise and its position is only to facilitate the business transactions and to meet the personal needs of its customers. This model is currently well accepted by most Islamic banks, which is also similar to the models adopted by corporate banking or capitalist banks in the conventional system. This model is appropriate to the capitalist system, as what is required by Muslim society is to finance their personal needs or economic activities in order to carry their personal use or to capitalize their enterprise of production, consumption or distribution activities. At present, we may conceive that these needs are demanded through various economic levels such as financing of consumer goods and services, domestic trade, international trade, corporate levels as well governmental operations. Apart from that, this approach must be

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<sup>140</sup> See his writing on justification of deferred contracts. Abdul Halim Ismail, "The Deferred Contracts of Exchange in the Qur'ān," in *An Introduction to Islamic Finance*, edited by Sheikh Ghazali Abod, Syed Omar Syed Agil and Aidit Ghazali (Kuala Lumpur: Quill Publishers, 1992), 285-313.

<sup>141</sup> *'Uqūd musammā* refer to the name of contracts, which have been established and found in the classical *fiqh* books, such *muḍārabah*, *mushārah* and *ijārah*, whereby *'uqūd ghayr musammā* refer to the name of contracts, which are not found in the classical *fiqh* books, such as options, futures, and swaps contract in derivatives contracts.



well-adjusted to the social dimensions in which the main objective of Islamic banking operations is not merely to seek profit but must respond to the social and environmental needs as well as to promote welfare economics. Concerning the aspect of Islamizing the conventional products, the practice should not be encouraged as it would be more costly, inefficient and would increase the risk of mispricing. Nonetheless, this model has been rigorously criticized by many scholars, especially by Islamic economists due to the approach's failure to take care of the social dimensions, public welfare, and the objectives of Islamic banking's establishment.<sup>142</sup>

It appears that Ismail's model is more consistent with the recent development of Islamic banking business which indicates that Islamic banks have attempted and expanded their operations in terms of introducing new and diverse products and services as propounded by the concept of becoming universal banks.<sup>143</sup> This means that Islamic banks may engage in various activities such as fund management as well as liquidity management such as issuing commercial papers and securitization.<sup>144</sup> However, this approach still implies that Islamic banks follow their counterparts -the conventional banks. It has been criticized that it is not capable of achieving the real objectives of Islamic economics which aim to provide social-welfare to the people, but instead it aims to satisfy the individual self-maximization and efficiency through Sharī'ah principles. The Islamic bank is regarded as a corporate and business entity, which is similar to the conventional bank, which aims primarily to satisfy the objectives of stakeholders and depositors, rather than to provide charity financing to the society.

### **1.5. Sharī'ah Standards in Legalizing Islamic Banking Products**

The process of determining and validating Sharī'ah -compliant products in Islamic banks is normally undertaken by the internal Sharī'ah department and Sharī'ah committee in the bank. Both departments are responsible for scrutinizing the product's structure, feature and design in order to ensure the product developed abides by all the Sharī'ah precepts. In Malaysia, the process to ensure a Sharī'ah -compliant product

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<sup>142</sup> El-Gamal, *Islamic Finance*, 24.

<sup>143</sup> A universal bank participates in many kinds of banking activities such as a commercial bank, investment bank, insurance company and other financial services. Stuart I. Greenbaum, Anjan V. Thakor, *Contemporary Financial Intermediation* (USA: Elsevier, 2007), 611.

<sup>144</sup> Ibid. 76.

may include various Sharī'ah frameworks, sources, principles, guidelines, and procedures as well as modern requirements of banking and finance, as issued by the regulator and the Sharī'ah committee, which can be delineated as follows:

### 1.5.1. The primary and secondary sources

The first standard to verify the compliance of the product the Sharī'ah is the Qur'ān and the Sunnah; however, these sources do not provide a comprehensive and detailed features or techniques on how to develop a product. Mostly, the sources only offer a general directive relating to moral and ethical values, which the Muslims are required to abide. In order to complement the primary sources to the existing Sharī'ah framework, Muslim jurists depend on various other sources recognized in the Sharī'ah such as consensus (*ijmā'*), analogy (*qiyās*), juristic preference (*istihsān*), presumption of continuity (*istiṣḥāb*), *maṣlahah* (public interest), *urf* (customary practices) to deduce Sharī'ah legal rulings. These sources must then be interpreted and deduced by a specific methodology of *uṣūl al-fiqh*. This refers to a methodology that expounds the legal indications (*adillah*) and methods (*qawā'id*) through which the rules of *fiqh* are deduced from the foundational texts, namely the Qur'ān. The Sunnah by the person who uses this methodology to deduce legal ruling is known as *mujtahid*.<sup>145</sup>

### 1.5.2. Islamic legal maxims

Another standard for product developers is Islamic legal maxims (*al-qawā'id al-fiqhīyyah*), which refer to a body of abstract rules derived from the detailed study of *fiqh*. They are part of *fiqh* or concise *fiqh* rules, but are different from *uṣūl al-fiqh*. The former is about the abstracts deduced from the body of *fiqh*, while the latter is the methodology through which the rules of *fiqh* are deduced. They contain theoretical guidelines in different areas of *fiqh*, such as ritual, criminal, evidence, transactions, matrimonial, and penalties law. Over 200 legal maxims have been collected and compiled in the works known as *al-ashbāh wa naẓā'ir* (resemblances and similitudes) by

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<sup>145</sup> For further information about *uṣūl al-fiqh* see Kamali, *Principles of Islamic Jurisprudence*, 1-5; Muḥammad Hashim Kamali, "Methodological Issues in Islamic Jurisprudence," *Arab Law Quarterly* 11, no. 1 (1996):3-33; Bakar, "Sharī'ah Approaches," 130.

Muslim jurists.<sup>146</sup> Among these legal maxims, there are five well-known Islamic legal maxims which apply to the entire range of *fiqh* without any specification, and most Islamic law's schools generally agreed over their classification. The first legal maxim is "matters are determined according to intention (*al-umūr bi-maqāṣidihā*)," which deals with the role of intention in Sharī'ah. The second legal maxim is "certainty is not dispelled by doubt" (*al-yaqīn lā yazūlu bi al-shakk*) that which is established with certainty is not removed by doubt. The third maxim is hardship begets facility (*al-mashaqqah tujlab al-taysīr*) which connotes that the presence of difficulty requires that alleviations be made to effect ease. The fourth Islamic legal maxim is "harm must be eliminated" (*al-ḍarar yuzāl*) denotes that whatever things or matters that cause harm should be eliminated and forbidden. Finally, the fifth Islamic legal maxim is "custom is authoritative" (*al-ʿaddah muhakkamah*) signifies that Sharī'ah does recognize customary practices or prevalent traditions, as long as they are not contrary to the universal principles of Sharī'ah, such as to legally recognize *ribā* or *gharar* as *ḥalāl* (permissible) in commercial transactions.<sup>147</sup> These legal abstracts are used to guide generally the concept of Islamic legal rulings without referring to the *fiqh* treatises.

### 1.5.3. Sharī'ah resolutions

It may be established that the above sources only provide general guidelines on how to determine the Islamicity of Islamic banking products. These sources are required to be interpreted and compiled in the form of abstract rules or legal codes or guidelines in order to ease the practitioner's reference to them. In Malaysia, the above sources are applied in the form of Sharī'ah resolutions (*fatāwā*) issued by the SACBNM. The compilation encompasses of all Sharī'ah resolutions made between 1997 and 2010 and it is a continuation of the earlier efforts to increase the understanding of the Sharī'ah interpretation and the juristic reasoning (*ijtihād*) for the Sharī'ah rulings. By exposing the resolutions, they are expected to increase the level of transparency on the means of juristic reasoning in Islamic finance and to foster their appreciation and acceptance among the industry players. They are also aimed to achieve more effi-

<sup>146</sup> Kamali, *Principles of Islamic Jurisprudence*, 5.

<sup>147</sup> Muḥammad Hashim Kamali, "Legal Maxims and Other Genres of Literature in Islamic Jurisprudence," *Arab Quarterly Law* 20, no. 1 (2006):77-101.

cient Sharī‘ah governance at the institutional level that promotes greater cross-border harmonization among other Sharī‘ah institutions in the interpretation and application of Sharī‘ah.<sup>148</sup>

Each resolution issued by the SACBNM is binding to the industry’s players, courts and arbitrators. As such, the applications of the most famous classical contracts are addressed in these resolutions. For example, the rules related to the practice of *ijārah*, *muḍārabah*, *mushāarakah*, *istiṣnā’*, *qarḍ*, *rahn* (mortgage), *takāful* (Islamic insurance), *wadi‘āh*, *wakālah* (agency), *hibah* (gift), *ibrā’* (waiver), *ta‘wiḍ* (compensation) and *gharāmah* (fine/penalty), as well as controversial contracts of *bay‘ al-‘īnah*, and *bay‘ al-dayn* (sale of debt), are also highlighted. The council also renders resolutions on the other types of financial products of financial derivative products, Islamic credit card, hybrid products, and *ṣukūk* (Islamic bonds). Furthermore, the resolutions also address the Sharī‘ah issues, in relation to the operations that supporting institutions that practice Islamic finance, such as Credit Guarantee Corporation (M) Berhad, Dana-jamin Nasional Berhad, Malaysia Deposit Insurance Corporation, and National Mortgage Corporation (Cagamas). In addition, the resolutions also underline various Sharī‘ah issues regarding accounting and auditing, and winding up of IFI.<sup>149</sup> From time to time, the Central bank of Malaysia also issues guidelines and procedural matters relating to banking issues in order to monitor and regulate the operations of Islamic banking. These guidelines include the capital adequacy ratios, financial reporting, liquidity framework, introduction for new products, establishment of Sharī‘ah committee, and Sharī‘ah governance.<sup>150</sup>

#### 1.5.4. The AAOIFI’s standards

The AAOIFI was established in 1991, in Bahrain and the composition of its member was and continues to be mostly from the international Islamic banking institu-

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<sup>148</sup> See BNM, *Sharī‘ah Resolutions in Islamic Finance*, xiv

<sup>149</sup> Ibid., iii-x.

<sup>150</sup> Bank Negara Malaysia, “Guidelines and Circulars,” accessed on 10 August 2013, [http://www.bnm.gov.my/index.php?ch=en\\_reference&pg=en\\_reference\\_index&ac=584&lang=en#banking](http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en#banking).

tions.<sup>151</sup> The objectives of the AAOIFI generally are to develop, disseminate, interpret, and review Islamic accounting, auditing, governance, ethics, and Sharī'ah standards relating to the activities of IBIs. The board also aims to achieve harmonization and convergence of opinion relating to the Sharī'ah interpretation to avoid any contradiction or inconsistency between the *fatwā* issued by the Sharī'ah boards. Furthermore, these standards, to some extent try to assist IBIs to develop Islamic financial institutions.<sup>152</sup> The AAOIFI has issued two standards, Sharī'ah standards and accounting and auditing standards. The former addresses various issues related to Sharī'ah matters in commercial transactions, while the latter is the standard that regulates the accounting, auditing and governance procedures of Islamic financial services. The accounting and auditing standards are aimed at promoting and enhancing transparency and confidence among the users of the financial statements of IBIs of the information, while the Sharī'ah standards aim to guide the practitioners concerning the principles and legal rulings of Islamic financial transactions.

These two standards are issued in accordance with the precepts of Sharī'ah. However, the accounting and auditing standards are also, to some extent, in conformity with the international accounting and auditing standards, such as International Accounting and Auditing Services Board (IAASB) and International Financial Report Services (IFRS).<sup>153</sup> Currently, for the accounting and auditing standard, the AAOIFI has 23 Accounting Standards, 5 Auditing Standards, 6 Governance Standards, 2 codes of ethics. Meanwhile, for the Sharī'ah standard; it has 41 standards that comprise of various approved contracts of the Sharī'ah. It was reported that only a number of countries have either fully adopted its standards or use them as guidelines for the Islamic banking sector, namely Bahrain, Sudan, Jordan, Malaysia, Qatar, Saudi Arabia, Dubai, Syria, Lebanon, Singapore, and South Africa.<sup>154</sup> Most of the countries that have Islamic financial services, including Malaysia, have adopted the accounting standards of IASB and not

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<sup>151</sup> Pomeranz Felix, "The Accounting And Auditing Organization For Islamic Financial Institutions: An Important Regulatory Debut," *Journal of International Accounting Auditing and Taxation* 6, no. 1 (1997): 123-130.

<sup>152</sup> AAOIFI, *Al-Ma'āyir al-Shar'iyyah*, xii-xv.

<sup>153</sup> Mohammed Amin, "What is AAOIFI's Proper Accounting Standards Role?" accessed on 20 October 2013, [http://www.mohammedamin.com/Islamic\\_finance/AAOIFI-proper-accounting-role.html](http://www.mohammedamin.com/Islamic_finance/AAOIFI-proper-accounting-role.html).

<sup>154</sup> Accounting and Auditing Organization for Islamic Financial Institutions, "A Word from AAOIFI's Secretary General," accessed on 10 August 2013, <http://www.aaofi.com/aaofi/AwordfromAAOIFISecretaryGeneral/tabid/198/language/en-US/Default.aspx>

the AAOIFI standards, since they are not globally recognized.<sup>155</sup> However, only Bahrain, Qatar and Jordan clearly and consistently apply the AAOIFI's standards. The adoption of the standards is considered on a voluntary basis. Malaysia attempts to reconcile the standards with the national requirements of accounting standards by adapting and making some changes to its accounting standards in order to avoid any conflict. However, most of its standards are parallel to the requirements of IAASB.<sup>156</sup>

#### 1.5.5. The IFSB's guidelines

The IFSB serves as an international standard-setting body for regulatory and supervisory agencies that have vested interests in ensuring the soundness and stability of the Islamic financial services industry.<sup>157</sup> The IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Islamic Sharī'ah principles and recommending them for adoption. It also provides guidance for the effective supervision and regulation of Islamic financial institutions (IFIs) that offer Islamic financial products and to develop the criteria for identifying, measuring, managing and disclosing risks for guidance of the Islamic financial services industry. In order to meet international standards, the IFSB also liaises and cooperates with relevant organizations of standard setting-body, such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors, in order to promote the stability and the soundness of the international monetary and financial systems of those of the member countries.<sup>158</sup> However, the adoption of the IFSB's guidance is conceded on a voluntary basis, and many countries that have IFIs, including Malaysia, have adopted some of the guidance as part of

<sup>155</sup> Shahul Hameed Mohamed Ibrahim, "IFRS vs AAOIFI: The Clash of Standards?" *MPRA Paper No. 12539*, posted 7. January 200, accessed on 10 August 2013, [http://mpra.ub.uni-muenchen.de/12539/1/The\\_Clash\\_of\\_Standards\\_international\\_accountant\\_article.pdf](http://mpra.ub.uni-muenchen.de/12539/1/The_Clash_of_Standards_international_accountant_article.pdf)

<sup>156</sup> Thea Vinnicombe, A Study Of Compliance With AAOIFI Accounting Standards By Islamic Banks In Bahrain," *Journal of Islamic Accounting and Business Research* 3, no. 2 (2012), 78-98; see also Adel Mohammed Sarea and Mustafa Mohd Hanefah, "The Need Of Accounting Standards For Islamic Financial Institutions Evidence From AAOIFI," *Journal of Islamic Accounting and Business Research* 4, no. 1 (2013): 64-76.

<sup>157</sup> IFSB's guidelines cover the Islamic banking, capital markets, and insurance's sector. IFSB, accessed on 10 August 2013, <http://www.ifsb.org/>; Hasan Laahasna and M. Kabir Hassan, "The Sharī'ah Process in Product Development and Approval in ICM," in *Islamic Capital Markets Products and Strategies*, edited by Kabir Hasan and Michael Mahlknecht (UK: John Wiley and Sons, 2011), 24-68..

<sup>158</sup> Ibid.

their regulatory framework. It differs from the AAOIFI, as it is an inter-government collaboration, whereas the AAOIFI is a private institution established by Islamic banks in the world to promote a harmonized Sharī'ah, accounting and auditing standards. Presently, it has issued 13 guiding principles of various Standards, 5 Guidance Principles and 1 Technical Notes.<sup>159</sup>

#### **1.5.6. The IIFAOIC's resolutions**

The International Islamic *Fiqh* Academy of the Organization of the Islamic Conference (IIFAOIC) based in Jeddah, Saudi Arabia is another Sharī'ah institution that has significantly contributed to development of Islamic banking and finance by resolving many Sharī'ah issues and issuing Sharī'ah resolutions (*fatāwā*). It was set up in 1986 under the auspices of the Organization of the Islamic Conference (OIC). The members of the academy are appointed from the Sharī'ah scholars, and jurists, as well as experts from various fields relevant to the field, such as economics, finance, medics, natural sciences, and law. The members meet annually in various locations, where various topics are discussed, and this include the matters of finance, banking and economics. Papers related to the agenda are prepared in advance before they are presented to the scholars. After the debate, a decision or *fatwā*, by majority of votes of those present in the meeting will be issued and the *fatwā* is then published in the journal of the academy. Up to date (2013), there have been 20 resolutions issued by the academy.<sup>160</sup>

#### **1.6. Sharī'ah Scheme of Contracts**

Since Islamic banking operations are based on various contractual agreements, in contrast to conventional banking, which is based on loans, then, it is pertinent to briefly discuss these Sharī'ah contracts. Many classifications exist to indicate their nature and the principles applied; non-commutative contracts, bilateral or commutative contracts, and accessory contracts. The first type of contracts is gratuitous contracts that do not involve any payment for its exchange. For some contracts, their conclusion does

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<sup>159</sup> IFSB, "Published Standards, Guidance Notes and Technical Notes," accessed on 8 November 2013.

<sup>160</sup> The Islamic Fiqh Academy, "Fatwa," accessed on 10 August 2013, <http://www.fiqhacademy.org.sa/>; Vogel and Samuel, *Islamic Law and Finance*, 48.

not require the consent of the acceptor and only can be undertaken by unilateral party, i.e. the offeror. For example, gift (*hadiyah, hibah*), off-sets the debt (*muqāṣṣah*), will (*waṣīyyah*), and *waqf* and loan.

Commutative contracts are pecuniary transactions that involve the transfer of ownership (subject matter) from one hand to the other hand with an exchange of consideration (price). The main of commutative contracts are sales, which engage in an exchange of a commodity or a good from the seller to the buyer, where the former transfers the ownership to the latter and the latter renders consideration (money) for the compensation of the ownership's handover. In order to make it valid, generally the subject must fulfill some conditions, such as the existence of the subject matter, lawfully owned by valid possessor and sufficiently valuable from the Sharī'ah perspective. It is also stipulated that the contracting parties involved must be qualified and competent persons, with clear manifestation of offer and acceptance of the will to conclude the contract. The contracts include *bay' murābahah* (sale at cost plus mark-up), trust sale (*amānah*), negotiation sale (*bay' musāwamah*), sale at cost price (*bay' al-tawlīyyah*), sale at below price (*bay' waḍī'ah*), *ijārah*, *salam*, *istiṣnā'*, and bidding sale (*muzāyadah*).<sup>161</sup>

Finally, accessory contracts deal with the assignment of work or capital or obligation from one party to another party, with or without consideration (price). The contracts still can be categorized under bilateral contracts, as they involve two or more parties in the transaction. However, they differ in that some of the contracts are not allowed to accept any consideration and some contracts are permitted to accept the consideration. Among the contracts that can be categorized under this classification are agency (*wakālah*), *muḍārabah* and *mushārah*, *kafālah* or *rahn* and debt transfer (*hiwālah*). Agency is a principal-agent relationship to perform specific duties assigned by the principal and it is permissible for the agent to receive advanced payment to perform his duties. Silent partnership is a contract which involves capital provider and an entrepreneur, where both share the profit as pre-agreed in the contract; however loss is borne only by the capital provider. Whereas, in active partnership, both the contracting parties contribute the capital, according to a pre-agreed ratio, and, share together the loss based on the proportion of the capital contributed. *Kafālah* (guarantee) is individual guarantee or third person, who guarantees other obligation concluded by other parties, especially

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<sup>161</sup> Ayub, *Understanding Islamic Finance*, 124.



in the context of debt obligation, where the *kāfil* (guarantor) will ensure that if the original debtor cannot pay the debt, he will complete the payment. While, *rahn* is also guarantee contract, but not a personal guarantee, however, based on holding a valuable non-fungible (*qīmī*) commodity, as an insurance against debt. Finally, debt transfer is where the original debtor transfers his debt obligation (from paying to the lender) to the third party. Hence, the original debtor is relieved from paying the debt to the lender and the responsibility is newly borne by the third part and the lender is required to claim the debt from the new owner, i.e. the third party.<sup>162</sup>

### 1.7. Prohibition of *Ribā* and *Gharar*

The presumption that interest rate, as applied in conventional financial transaction is similar to definition of *ribā* by majority of scholars, has turned out to be the main factor that makes Muslims' engagement in conventional banking is problematic, if not altogether prohibited. Nevertheless, this presumption has been contended by few scholars that interest rate is not equivalent to *ribā* since there are some practices of Islamic banking that embed the interest rate as the underlying principle. This has caused some issues in the modern Islamic banking. Therefore, the discussion of what is exactly meant by interest rate and *ribā* and how the modern scholars contend about the definition is necessary to be examined in this respect. The prohibition of *ribā* transaction is clearly spelled out in both primary sources (i.e. the Qur'ān and the Sunnah) of Islam, in which Muslims are prohibited from indulging in any business and transactional matter that involves the ingredient.

*Ribā* or usury literally means increment, excess or increase, which is derived from the root verb of “*rabat*,” which also means yield and increase. Allāh said, “*But when we send down rain to it, it is stirred to life and yields increase*”.<sup>163</sup> Technically, it means “increment in a specific thing”<sup>164</sup> and it is usually translated as usury or excessive interest or usurious interest in modern connotations.<sup>165</sup> *Ribā* is undeniably forbidden in the Islamic legal traditions, as it is clearly mentioned in various verses of the

<sup>162</sup> Wahbah al-Zuhaylī, *al-Fiqh al-Islāmī wa Adillatuh* (Bayrūt: Dār al-Fikr, 1983), v.5, 181.

<sup>163</sup> Sūrah al-Fuṣṣilat, 41:39.

<sup>164</sup> Maṣṣūr ibn Yūnus al-Buhūtī, *al-Rawḍ al-Murbi‘ bi Sharḥ zād al-Mustaḥni‘* (Riyad: Maktabat al-Ḥadīthah, 1390H) vol.2, 106.

<sup>165</sup> Ibid, Rayner, 267.

Qur'ān (2:275-81, 3:130-2, 4:161 and 30:39). This *ribā* is known as *ribā al-nasī'ah* (*ribā* of deferment). Although the prohibition is unequivocally stipulated in the above verses, but the interpretation, scope of the prohibition and its applicability to practical life raise several inquiries from scholars on the concept of *ribā*. This is because the meaning of *ribā* in the classical term is not in tandem with the understanding of modern banking applications. Besides the *ribā* mentioned in the Qur'ān, there is another type of *ribā*, which is prohibited by the Prophet, known as *ribā al-buyū'* or *ribā al-faḍl*, which can be translated as *ribā* in exchange. There are many *aḥādīth* (the prophetic traditions) narrated to insist of its prohibition and one of them is narrated by Abū Sa'id al-Khudri that states “*Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ then sell them as you wish, if it is hand to hand*”.<sup>166</sup> The *aḥādīth* (*ḥadīth* -singular) indicate that the exchange of the monetary items and commodities must be made in spot and equal quantity; otherwise, it will fall under the definition of *ribā*.

Based on the Qur'ānic verses and the *aḥādīth*, the majority Muslim scholars have classified *ribā* into two types namely (1) *ribā* of deferment (*ribā al-nasī'ah*) in loan transaction and (2) *ribā* in excess due to exchange (*ribā al-faḍl*). *Ribā* of deferment in loan is the act of extending a delay to a debtor in return for an increase in the borrowed principal. It was widely practised at pre-Islam and at the time of the Prophet. The practice of *ribā* transaction during the pre-Islamic period was recorded by Mālik (d.179/795) in *al-Muwatṭā'*. He narrated that *ribā* in the pre-Islam occurred when a man gave a loan to another for a set term, but when the term was due, the lender would say, “will you pay it off or increase (it for) me?” If the borrower paid, he took it. If not, the lender increased the debt and lengthened the term for the borrower.<sup>167</sup>

The prohibition of *ribā al-nasī'ah* indicates that any compensation or increment more than the borrowed principal was initially prohibited in early Islam, irrespective whether the loan was intended for consumption or production purposes. As for a consumption loan, the practice of charging *ribā* was viewed as undermining the charitable attitudes and human kindness among Muslims. It opposes early Islamic teaching that encourages the support of the poor by the rich. Muslims are asked in the Qur'ān to sac-

<sup>166</sup> Aḥmad ibn 'Alī Ibn Ḥajar al- 'Asqalānī, *Fath al-Bārī bi Sharḥ Ṣaḥīḥ al-Bukhārī* (Bayrūt: Dār Ihyā' al-Turāth al- 'Arabī, 1981), vol. 4, 302.

<sup>167</sup> Mālik Ibn Anas, *al-Muwatṭā'* (Bayrūt: Dār al-Gharb al-Islāmī, 1997), vol.2, 1997, 204.

rifice the possibility of a profitable opportunity when giving loans to others. In addition, Muslims are also recommended to extend the time to the borrowers when they are having problems in repaying their loans.<sup>168</sup>

Second type of *ribā* is *ribā al- faḍl* or *ribā* of exchange, which normally occurs in sale transaction. As stated in the above *ḥadīth* narrated by Abū Saʿīd al-Khuḍrī, the requirement of equality and spot transactions are necessary when exchanging similar *ribāwī* items or barter transaction. For example, exchange of the same quality of dates is permitted only in equal amount (e.g. one kilogramme for one kilogramme) and performed without any time interval. If the *ribāwī* items are dissimilar (e.g. wheat for barley), the exchange must be done in spot transaction. The prohibition of the two types of metal and four types of commodity is because they are regarded as the currency's denominator and nourishment's item, respectively, at that time, which are very important for the survival. Hence, any practice of *ribā* to the commodities and currencies will pressure the need of the poor in society.

Notwithstanding, a question can be raised about other currency's denominator or nourishment's commodity such as a paper money or copper (types of currency) or apple or rice (types of commodity)? In this respect, Muslim jurists have used analogical reasoning (*qiyās*) to extend the original rule to the new cases, such as mentioned. For this purpose, they create the same denominator or effective causes (*ʿillah*) to the original cases. However, they differ in opinion about the effective cause that can give the same effect to the original cases. The effective causes for the Ḥanafīs are “measurable” and “weighable,” while for the Mālikīs, they are storable nourishment and currency. Meanwhile, for the Shāfiʿīs, they are foodstuffs and currency and the Ḥanbalīs are measureable, weighable or currency.<sup>169</sup>

Consequently, the difference of the effective cause, as pointed by Saeed (1995) often led to the incompatible outcomes.<sup>170</sup> For example, following the opinion of the Ḥanafīs, one egg, or apple can be exchanged with two eggs or two apples and the exchange can be deferred, as they are not “measurable” or “weighable”. On the other hand, for the Shāfiʿīs, the transaction is not allowed as they are being categorized as

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<sup>168</sup> Umer Chapra, *Towards a Just Monetary System* (Leicester: The Islamic Foundation, 1985), 64.

<sup>169</sup> Abdullah Saeed, *Islamic Banking and Interest: A Study on the Prohibition of Riba and Its Contemporary Interpretation* (Leiden: Brill Publication, 1995), 34.

<sup>170</sup> It is seemed that Saeed adopted the opinion of Rahman. Accordingly, Rahman does not regard every interest is *ribā* or vice versa, which contrary to majority's view on *ribā*. Fazlur Rahman, “Ribā and Interest,” *Islamic Studies* 3, no. 1 (1964): 1-43.

foodstuffs. For the Mālikīs, the exchange is also not allowed since they are categorized as storable nourishments. Meanwhile, for the Zāhirīs, (literal schools), the transaction is allowed since they only apply the literal interpretation of the *ḥadīth* and the prohibition only applies to six items of the commodities.<sup>171</sup> Saeed (1995) contends that Muslim jurists that extend the ruling of the prohibition based on the *‘illah* did not consider the element of morality and the *ḥikmah* behind of the prohibition of *ribā*. Most Muslim jurists prefer *‘illah* to *ḥikmah* because the former could be used effortlessly and objectively, whereas, with the latter many aspects have to be deliberated before reaching a decision. However, the advantage of the decision that is based on *ḥikmah* is that it could accommodate the circumstances that change; whereas, a decision arrived through *‘illah* would remain “immutable”.<sup>172</sup>

Saeed (1995) furthermore explains that if the effective cause were given as a basis for the prohibition of *ribā*, then any increase in loan or debt accruing to the creditor over and above the principal would be considered *ribā*. However, if the justification were based on *ḥikmah*, only those involving an “injustice” to one would be prohibited. This is because in the same verse that stated the prohibition on *ribā* Qur’ān, Allāh said, “[d]o not commit injustice and no injustice will be committed against you,” (Sūrah al-Baqarah: 279). In this respect, he argues that the *‘illah* approach is easily used, as compared to *ḥikmah*, which requires the jurists to look at each transaction in order to determine what is injustice exists, before it can be decided that the transaction is *ribā* or not *ribā*. Although, the justification of *‘illah* is easily used, he advances that sometimes the approach may not serve the intended purpose of the particular rule in the Qur’ān resulting most Islamic banking products in the market are *ḥiyal*-based products.<sup>173</sup> In this respect, he opined that not every interest is *ribā* and not every *ribā* is interest, which was supported by another academician, El-Gamal (2000, 2006).<sup>174</sup>

El-Gamal (2006) maintains that *ribā* that was meant in the Qur’ān and the Sunnah is not the same as what is practiced in the conventional banking system. He argues

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<sup>171</sup> Ibid. 35.

<sup>172</sup> Ibid., 36.

<sup>173</sup> Ibid., 37.

<sup>174</sup> There are many arguments have been discussed by scholars, and one, who have interest to embark to this study can refer to the work Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law, Ribā, Gharar and Islamic Banking* (London: Graham and Trotman, 1992). However, this study only emphasizes on the recent scholarly works of three scholars, namely Abdullah Saeed (1996), Mahmoud A. El-Gamal (2006), Zamil Iqbal and Abbas Mirarkhor (2008) Maha-Hanaan Balala (2011), and finally Muḥammad Akram Khan (2013) on their opinion of *ribā*’s discussion.

that even the most conservative Muslim jurists do not take into account what economists and regulators call interest as to the forbidden *ribā*. The best illustration is in the mark-up credit sales and lease to show that they are embedded with implicit “interest rate” that is called profit rate in order to determine the return and rental’s charge, respectively, which is not “interest-free”. Based on the practice in the United States, the regulator stipulates that the IFIs, which offer Islamic financial services, are required to report the implicit interest rates they charge to their customers. Hence, the practice of Islamic finance itself illustrates, obliquely, the fact that some forms of interest (e.g. credit sales) should not be considered as forbidden *ribā* <sup>175</sup>

Another scholar, Balala (2011) contends that the Qur’ān has only prohibited *ribā* that has an inequitable and inefficient gain in commercial dealings.<sup>176</sup> She maintains that the inequity and inefficiency can be determined through a regulated and competitive market that is marked to the market and deviated away from it would be inequitable and inefficient.<sup>177</sup> Hence, contemporary interest is not *ribā*, as it is competitive and regulated by the market, which is equitable and efficient. However, financial transactions that do not have an organized commercial markets (money market), could be involved in *ribā* transaction, as the interest charged probably is exorbitant and can do injustice to the borrower. Thus, any gain in interpersonal loans would be *ribā*, as it is taken and given in an unregulated environment, whereas it would not be conceded as *ribā*’s gain in conventional commercial banking, because the interest charged on the loans is marked-to-market or done in organized system.<sup>178</sup>

Meanwhile, Khan (2013) observes that most of the Muslim jurists would regard a transaction to involve the element of *ribā*, when it triggers the following occasions: (i) it has to be a transaction of monetary exchange where the principle sum has to be returned with an increase, (ii) the increase is predetermined either as an absolute sum or as a rate for a period, (iii) and finally, it will not matter, whether the rate of interest is

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<sup>175</sup> El-Gamal, *Islamic Finance*, 51; Mahmoud A. El-Gamal, “An Economic Explication of the Prohibition of Ribā in Classical Islamic Jurisprudence,” accessed on 26 April 2013, [www.ruf.rice.edu/~elgamal/files/riba.pdf](http://www.ruf.rice.edu/~elgamal/files/riba.pdf).

<sup>176</sup> Maha-Hanaan Balala, *Islamic Finance and Law: Theory and Practice in a Globalized World* (London; New York: I.B. Tauris, 2011), 62-95.

<sup>177</sup> Ibid. 87.

<sup>178</sup> For example, she argues that interest rate, that is currently practiced by conventional finance is capped by various contemporary anti-usury laws (in the US) and credit regulatory framework (in the UK) that protect those in need of credit against predatory lenders or otherwise illegitimate stipulations of gains on transactions. Hence, as such condition, if interest is imposed, it is permissible. However, in the situation that interest rate is unregulated, where the party can charge excessive rate of interest, it is prohibited *ribā*. Ibid. 76.

high or low; or what the purpose of loan or monetary exchange is (consumption or commercial); or what the period of the transaction is (any span of time); or who are the parties in the contract (individuals, institutions, government, inter-governmental bodies, and non-government organizations).<sup>179</sup> It seems that Khan (2013) agrees with the majority of Muslim jurists that “*ribā* is interest and interest is *ribā*”. However, this assumption is misleading, as he also argues that not all interest is *ribā*. He attempts to differentiate between interest - which also can be called as financial claims on loans- and *ribā* in trading, financial and investments financing that have been used in developing Islamic banking products. For him, only interest on loans can be regarded as *ribā*, but other charges, such profit rates or dividends based on interest rate are not *ribā*. He justifies this argument based on the observation of the contemporary Muslim jurists that recognized the hidden interest rate that is being charged in trading, financial and investment financing.<sup>180</sup>

As a conclusion, most progressive thinkers assert that not all interest is prohibited and mostly they do not agree with the interpretation of conventional opinions. They justify that the rationales given by traditional scholars are not satisfactory and unjustifiable in the modern context. They argue that Muslim jurists prohibit the interest on loans but permit the use of interest rate, as a benchmark for the profit rate in *murābahah*, *ijārah*, *istiṣnāʾ* and *salam* and other financing and investment of Islamic banking products. They argue that the rate of return used in loans is similar to the interest rate in sale exchange, and it raises the question - why is the former prohibited but the latter is not. They reject the justification given by traditional scholars that the former contracts involve risk, whereas, the latter does not, for this is not a fair treatment for the borrower, as in the practical reality, the sale exchange, such as *murābahah* can be concluded, in minutes, if not seconds, of the transaction, without taking any risks.

Notwithstanding, the above views are still not accepted by the majority of jurists and the Sharīʿah authorities. Many Islamic banking institutions still adopt the mainstream interpretation of *ribā* that *ribā* is interest and interest is *ribā*. Iqbal and Mirarkhor (2008) argue that most Muslim jurists currently assume the meaning of *ribā* defined in the Qurʾān and the Sunnah is equivalent to the interest practiced in conventional financial institutions today. According to the authors, *ribā* is the premium or ex-

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<sup>179</sup> Khan, *What is wrong with Islamic Economics*, 142.

<sup>180</sup> Ibid., 236-237.

cess that must be paid by the borrower to the lender with the principal amount as a condition for the loan provided or for an extension given while the loan's payment is due. There are at least four characteristics that can describe the prohibited interest in conventional banks: (i) it is positive and fixed *ex-ante*, (ii) it is tied to the time period and the amount of the loan, (iii) its payment is guaranteed regardless of the outcome or the purpose for which the principal was borrowed, and (iv) the state apparatus sanctions and enforces its collection.<sup>181</sup> Based on the facts, Muslim jurists totally reject the interpretations, as follows; (i) that *ribā* is only prohibited in commercial but not production, (ii) that *ribā* is prohibited in excessiveness/compounding but not in low interest rate, (iii) to reject readjustment of the value of money borrowed because of inflation, as it is equivalent to the amount increased in the loan and finally (iv) to reject the concept, time value of money in loans, but not in sale exchanges.<sup>182</sup>

*Gharar* is another important element that may vitiate Islamic financial transactions. Literally, *gharar* means deceit or fraud, but in commercial transaction, it is often being used as uncertainty, risk, hazard, and peril that may lead to destruction and loss. *Gharar* as a general connotation may carry different meanings in different kind of transaction. Kamali (1998) explains that Muslim jurists have differed broadly in opinion on the definition of *gharar*. For example, Ibn 'Ābidīn (d.1836) asserts that uncertainty is related to doubt about the existence of subject-matter.<sup>183</sup> Meanwhile, Ibn Ḥazm (d.1064) denotes it as ignorance of the material attributes or features of the subject matter. On the other hand, majority of the Muslim jurists regard that uncertainty is a combination of both features; doubt on the existence and attributes of the subject-matter.<sup>184</sup>

The prohibition of *gharar* has been uttered by the Prophet in many *aḥādīth*. The most well-known is, "it is prohibited the sale of *gharar*".<sup>185</sup> Nonetheless, this *ḥadīth* is too general to describe the characteristics or features of *gharar* and this attracts various opinions among Muslim jurists about what was meant by the Prophet and what is the

<sup>181</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, (US: John Wileys and Sons, 2007), 56.

<sup>182</sup> Ibid., 57-62.

<sup>183</sup> Muḥammad Amīn ibn 'Umar Ibn 'Ābidīn, *Ḥāshiyat Radd al-Muḥtār 'alā al-Durr al-mukhtār sharḥ Tanwīr al-absār* (al-Qāhirah: Matba'ah al-Bābī al-Halabī, 1966), vol. 4, 147; Muḥammad Hashim Kamali, *Islamic Commercial Law: an Analysis of Futures and Options* (Kuala Lumpur: Ilmiah Publisher, 2002), 84-85.

<sup>184</sup> Muḥammad 'Alī ibn Aḥmad Ibn Ḥazm, *al-Muhallā* (Bayrūt: Dār al-Kutub al- 'Ilmiyyah, 1988), vol. 7, 343; Kamali, *Islamic Commercial Law*, 84-85.

<sup>185</sup> Ahmad Hidayat Buang, "The Significance of Prohibition of Gharar towards the Formulation of Essentials of Contract (Arkān) in Islamic Mu'āmalāt: An Analysis from the Qur'ān and Ḥadīth," *Al-Bayān Journal of al- Qur'ān and al-Ḥadīth* 2 (Mei 2004):171-188.

nature of sale with uncertainty. Ibn Taymīyah (d.1328) attempted to describe the nature of this sale by indicating that *gharar* sale that was meant by the Prophet is a sale, which involves risk-taking and unlawful devouring of the property of others. The risk-taking involved, with regard to the uncertainty of the attributes or the deliverability or the existence of the sale's object. It has also been drawn that the authority of the *ḥadīth* is also very weak, and cannot become as a *hujah* (argument) to justify any legal rulings deduced or stemming from it.<sup>186</sup>

Nonetheless, the nature of *gharar* has been provided by other *aḥādīth*, as asserted by Ibn Rushd (d. 1198), such that it was prohibited to sell the offspring of an unborn animal (*ḥabal al-ḥabalah*), or fruit prior to its ripening, sales of *mulāmasa* (touched sale), *munābadhah* (thrown sale) and *al-ḥassat* (pebble sale), two sales in one sale (*bay' atayn fī bay'ah*), of what is in the loins and wombs (*bay' al-madāmin wa al-malāqih*), of something that is not in one's possession (*bay' al-ma'dum*) and others. These transactions were mainly prohibited because they involved uncertainty with the existence or attributes, or both, of the sale's object, and price.<sup>187</sup>

In this respect, it is also asserted that *gharar* does not only happen to the subject-matter of the contract, but also other pillars in the contract, such as uncertainty on expressing offer and acceptance, determination of price, the age and capacity of the contracting parties, and other elements related to the contract. Hence, doubt in expressing of the offer, for example, will lead to uncertain transactions, as it happened in a transaction that combines two sales in one sale, where the offeror mentions two types of price to the buyer, and both parties leave the contractual session without indicating the agreed price. Furthermore, it is agreed by the majority of Muslim scholars that the contracts affected with *gharar* are only the types of commutative contracts, such as *bay'*, *ijārah*, *salam*, and *istiṣnā'*, but not non-commutative contracts, such as *ṣadaqah* (donate), *hibah* (gift), *waqf*, and others, it has been argued that it is tolerable *gharar*.<sup>188</sup>

Meanwhile, the position of the Sharī'ah boards such as the AAOIFI, also defines *gharar* similarly to the above mentioned position of the Muslim jurists, which refers to the uncertainty that existed when the process of concluding a transaction involves an unknown aspect and when the result of the transaction may or may not mate-

<sup>186</sup> Taqī al-Dīn Abū al- 'Abbas Aḥmad ibn Ḥalīm ibn 'Abd al-Salam ibn 'Abd Allāh Ibn Taymīyah, *Naẓ-āriyyah al- 'Aqd* (Bayrūt: Dār al-Ma 'rifah, 1317H), 225.

<sup>187</sup> Kamali, *Islamic Commercial Law*, 86; Ahmad Hidayat Buang, *Studies on Islamic Law of Contract: The Prohibition of Gharar* (Kuala Lumpur: International Law Book Services, 2000), 40-60.

<sup>188</sup> Kamali, *Islamic Commercial Law*, 85



rialize.<sup>189</sup> The board divides *gharar* into three categories, namely *gharar al-fahīsh* (excessive uncertainty), *gharar al-mutawasiṭ* (moderate uncertainty), and *gharar al-yasīr* (minor uncertainty). *Gharar al-fahīsh* is defined as uncertainty, doubt or ignorance about the nature and attributes of transacted object, existence of the object, and exact information concerning the price or the unit of currency or the mode of payment. It also may happen, when there is uncertainty on the prospect of the delivery of the object, or the ability of vendor to deliver it intact as specified in the contract in the case of deferment or in a fit condition until the delivery time.<sup>190</sup> The AAOIFI noted that *gharar* is excessive, when its element dominates the contract (e.g. incapability to deliver subject matter) and can lead to disputes among contracting parties. As such, selling of fruits before production, signing a lease contract for unspecified period, or sale of forward commodity that is not available on date of delivery are conceded null and void.<sup>191</sup> Nonetheless, the examples of the AAOIFI's standards are too classical and they are not related to any contemporary examples such as dealing with futures and forward transaction, which are still being disputed by Muslim jurists.

Furthermore, *gharar al-yasīr* is the degree of uncertainty that a contract is difficult to avoid and its existence does not cause dispute among the contracting parties. For instance, a seller sells a house, where the buyer does not see its foundation or a landlord says to a lessee in a general statement that he intends to lease his house for one month, whereas the months in a year differ in length. This uncertainty does not affect the validity of the contract, as in the former case, the house is available, but due to hardship to show the house, then the uncertainty is tolerable. In the latter case, the utterance of the landlord that he will lease his house for one month approximately is still acceptable, because in the customary practice, such difference does not raise dispute between them. Otherwise, if the dispute arises, the landlord should stipulate the date precisely. Nevertheless, *gharar* is affected by certain types of fiduciary contracts, such as *murābaḥah* (cost plus profit), where if a slight *gharar* exists in the contract, then it will vitiate the contract.<sup>192</sup> Notwithstanding, *gharar al-mutawasiṭ* refers to uncertainty, which falls between excessive and minor, for instance sale of underground commodities or commodi-

<sup>189</sup> Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Al-Ma'āyir al-Shar'iyyah: al-Naṣṣ al-Kāmil lil-Ma'āyir al-Shar'iyyah lil-Mu'assasāt al-Mālīyah al-Islāmiyyah* (Manama: AAOIFI, 2010), 420.

<sup>190</sup> Ibn Rushd, *The Distinguished Jurist's Primer*, 179-187.

<sup>191</sup> AAOIFI, *Al-Ma'āyir al-Shar'iyyah*, 420.

<sup>192</sup> Liaquat Ali Khan Niazi, *The Islamic Law of Contract* (Lahore: Research Cell, 1990), 124.

ties that cannot be known unless broken or leasing of fruit trees. It also exists in contracts of *ju'alah* (payment of a specific reward for a task), guardianship, companies and fixed-term *mudārabah*.<sup>193</sup> This type of *gharar* is tolerable, as long as the *gharar* does not raise any dispute among the contracting parties.

To declare that contract or transaction has *gharar*, it must satisfy four conditions, ; (i) it must be excessive and not minor (ii) it must engage commutative contracts, where in non-commutative contracts are acceptable (iii) it must affect directly the subject matter, as opposed to the subject that is attached to it, and finally (iv) the contract concerned should not be a need to people. If there is a need for it (*darūrah*), then it can be ignored, although it is excessive. The reason for this is that satisfying a need takes precedence by virtue of the Qur'ānic injunction to remove hardship and to appeal benefits. This can be illustrated in the case of *salam*, where the Prophet allowed the practice, although the subject-matter did not exist yet at the contractual session. The permissibility of *istiṣnā'* is also considered as part of this principle, since its subject-matter is also not available at contractual session, and it is based on the principle of necessity required by the people, as insisted on by the Ḥanafīs.<sup>194</sup>

To sum up, *gharar* is a broad concept that consists of uncertainty, risk taking, excessive speculation, gambling and ignorance about the aspects of contract (e.g. the attributes and deliverability of subject matter, price, contracting parties and expression). Thus, the attempt to isolate some of these meanings and to narrow down the concept is less than warranted. This enquiry has shown that *gharar* is unavoidable as hardly any contract is totally free from *gharar* and the salient question is often that of whether the *gharar* in question is exorbitant or not. Furthermore, the relativity of the questions of *gharar* in which at the earlier times, some of the examples presented were deemed as unacceptable *gharar*, such as sale something without one's possession, has been accepted by society based on the judgment of customary practice (*'urf*).

## 1.8. Conclusion

The above arguments present our case that there were specific reasons for the concepts and principles working behind the Islamic banking activities. It also explains

<sup>193</sup> AAOIFI, *Al-Ma'āyir al-Shar'iyyah*, 421.

<sup>194</sup> Kamali, *Islamic Commercial Law*, 86-89.

that these concepts and issues will influence the forms and techniques of developing Islamic banking products. It is not simply an understanding of the above propositions that will render Islamic bankers capable of developing any product. Various methods and knowledge of Islamic banking especially a deep understanding of the Sharī'ah principles and their objectives are very important in order to develop products that are not only compliant with the Sharī'ah principles of contracts, but also to ensure the socio-economic justice. Moreover, this understanding will reflect the concept, strategy, and design of Islamic banking products that we shall treat it in the next chapter.

In addition, the prohibition of *ribā* and *gharar* in Islamic banking is regarded as the main component in the Islamic banking system because their harms outweigh the benefits. It is observed that the main attention of Islamic bankers is to avoid *ribā* or interest as much as possible of its element in Islamic banking transactions. However, to what extent Islamic banking system capable to avoid *ribā* in its product development is still questionable, since it becomes the main underlying principle in the modern banking, as we shall explore this issue throughout of this study. In contrast, despite its prohibition in the Sharī'ah, *gharar* is allowed in instances that its benefits outweigh the harms. It is permitted if the public need for it, although the level of uncertainty is excessive because of the Qur'ānic principle of removal of hardship and adversity. The Sharī'ah, hence validates contracts that are considered uncertainty, such as *bay' salam* (forward sale) and *bay' istiṣnā'* (manufactured sale), regardless of the uncertainty elements therein, simply because of the people's need for them. Generally, both elements are required in developing Islamic banking products.

## CHAPTER 2: PRODUCT DEVELOPMENT IN ISLAMIC BANKING: CONCEPT AND PROCESS

### 2.1. Introduction

*Key on the development of Islamic finance in Malaysia has been its progressive internationalization and the introduction of more innovative Shari'ah-compliant financial solutions that meet the increasingly more complex and diverse international business requirements. (Zeti Akhtar Aziz, 2012).<sup>195</sup>*

This chapter aims to elaborate the conceptual framework, i.e. the theory and approach in innovating and developing Islamic banking products. The present chapter starts with the overview of product development in the banking sector, then, ensues with the nature of product development. This is followed by a discussion on the concepts of developing Islamic banking products. Then, this is followed with various discussions, especially on the general principles, approaches, and Shari'ah approval process.

### 2.2. The Concept of Product Development

Product development frequently refers to the process of how a certain new product is created, innovated, and developed. In marketing studies, there is a focus on improving business performance by satisfying customer needs, where it examines the marketing activities and processes, such as environmental analysis, strategy and planning, advertising, branding, or channel management. This goal of improvement is known by various titles, such as development of original product, product improvement, and product modification. This process leads to new brands through the firm's own research and developmental efforts. As such, product development is considered an external force, rather than being an internal factor of an organization.<sup>196</sup> Precisely, it can be described as the complete process of bringing a new product to the market; either a tangible or an intangible one. The process will involve various steps and activi-

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<sup>195</sup> Zeti Akhtar Aziz, "Islamic Finance: New Frontiers in Financing the Economy," (Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the EU-Malaysia Chambers of Commerce and Industry's (EUMCCI) Quarterly Financial Panel Discussion 2012 "Islamic finance – new frontiers in financing the economy", Kuala Lumpur, 8 March 2012)

<sup>196</sup> Philip Kotler and Gary Armstrong, *Principles of Marketing* (Pearson Prentice Hall, 2008), 253.

ties such as idea generation, product design and detail engineering, market research and marketing analysis to ensure that the product developed would gain its place in the market. Although product development is often associated with the processes it entails, the scope is broader than that. It is also related to different types of innovation, various designs, structures and mechanisms that may be used to develop the product.<sup>197</sup> However to regard it as an external force is inaccurate, since it involves the internal forces and the whole capacity in a financial institution to produce innovative products and may even constitute an independent department in its own right. The department of product development would be a part of the internal organ of the institution that would function similarly to the other departments, such as, finance, human resources, marketing, or corporate relations.

In financial studies, the definition of product development seems similar to financial innovation and financial engineering. According to Franklin and Douglas (1994), financial innovation refers to the provision of opportunities for risk sharing, or intertemporal smoothing. It also refers to any activity that helps firms and individuals share risks and smooth fluctuations in income and expenditures.<sup>198</sup> Meanwhile, financial engineering is often related to the process which involves mathematical assumptions, prototypes, or models in designing, and pricing of innovative financial products that offers a better risk-return combination and enhances the profitability for the offering institutions. It also engages the application of some analytical tools to financial problems, especially the pricing and structuring of financial instruments such as the derivatives products.<sup>199</sup> From this perspective, it seems that the term financial engineering and innovation are used interchangeably. Financial innovation seems synonymous to the nature of product development in banking, whereas financial engineering is more connected to mathematical assumptions. However, financial engineering is also regarded similar to gambling and betting activities, since it involves the calculation of the

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<sup>197</sup> A. John and C. Storey, "New Service Development A Review Of the Literature and Annotated Bibliography," *European Journal of Marketing* 32, no. 3-4 (1998): 84-251.

<sup>198</sup> Franklin Allen and Douglas Gale, *Financial Innovation and Risk Sharing* (Cambridge: MIT press, 1994), 5-7.

<sup>199</sup> Sami al-Suwailem and M. Kabir Hassan, "An Islamic Perspective of Financial Engineering," in *Islamic Capital Markets Products and Strategies*, edited by Kabir Hasan and Michael Mahlkecht (UK: John Wiley and Sons, 2011), 385-400.

possibilities and chances of winning, rather than a productivity financial improvement.<sup>200</sup>

Product development is critically important to retain customers and survival of financial institutions. Customer retention is a result of customer satisfaction and loyalty towards the services and products offered by the financial institutions.<sup>201</sup> A satisfied customer is often a regular customer and a great source of referral for the financial institutions to enhance the features of their products. Without introducing a new product, a financial institution is incapable of retaining the customers who may look for other banking institutions that can provide better quality services. As a result, the financial institutions would be unable to compete with their competitors in the industry, and that may jeopardize its existence in the industry. Moreover, product development is also regarded as a catalyst for creating interest and energy in the development of the Islamic financial services. Thus, effective product development creates a synergy between the customers and the financial institutions. Both gains valuable insights from the interaction and this can assist financial providers to better understand the needs of its customers.<sup>202</sup>

Financial services sector is also a highly competitive industry and its products are easily imitated by others. Thus, it is important for the product to be sound and practical in all aspects in order to protect and enhance the reputation of those institutions that are offering the products. Furthermore, the trend of deregulation of the financial services sector in some jurisdictions has increased. For example, in the United States; the regulatory barriers have been loosened up and it has allowed financial providers to conduct more activities than it could before. For instance, they can now join more high risk investment in order to increase efficiency and growth, and to separate from the government intervention in the economy.<sup>203</sup> Thus, only financial institutions that can offer products that are commercially viable and robust can compete in that particular

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<sup>200</sup> Oxford Dictionaries relates 'innovation' to a process of innovating new ideas, Oxford Dictionaries, "Innovation," accessed 14 June 2013, <http://oxforddictionaries.com/definition/english/innovation?q=innovation>.

<sup>201</sup> A.J. Zahorik, and R.T. Rust, "Modeling The Impact of Service Quality on Profitability: A Review," in *Advances in Services Marketing and Management*, edited by T.A. Swartz,, D.E. Bowen, and S.W. Brown, vol. 1. JAI Press, Greenwich, CT, 1992), 247-76; Roger Hallowell, "The Relationships of Customer Satisfaction, Customer Loyalty, and Profitability: An Empirical Study," *International Journal of Service Industry Management* 7, no. 4 (1996): 27-42

<sup>202</sup> Gainor, "A Practical Approach to Product Development," 1-13.

<sup>203</sup> Matthew Sherman, "A Short History of Financial Deregulation in the United States," *Center for Economic and Policy Research*, accessed on 20 June 2013, <http://www.openthegovernment.org/sites/default/files/otg/dereg-timeline-2009-07.pdf>

environment.<sup>204</sup> In the meantime, this could benefit customers, as the increased competition among financial institutions to provide quality products and services is generally favorable to customers. They would have many choices for selecting products that can give good results to their needs and interests.

A banking product constitutes a mixture of many features including size, yield, various risks, duration and marketability pricing rules.<sup>205</sup> The product is developed through a complex innovation process by combining these elements. Thus, to comprehend the characteristics of the financial product, it would require a specific explanation of its features and attributes. Banking products are often referred to as intangible items, known as services. Banking products have distinct characteristics such as intangibility, simultaneity, heterogeneity, and perishability.<sup>206</sup> Intangibility simply means services. Unlike physical products, it cannot be seen, touched, or examined prior purchasing it but can be experienced after being exposed to them and are usually consumed concurrently with their production. Secondly, simultaneity means that services bring the customers into direct contact with the service delivery system. Therefore, the customers' perception of the quality of the product may be influenced by the appearance of the service delivery system, as well as by the quality of the service itself. Thirdly, services are heterogeneous – i.e. their quality depends on the performance of the service provider. They may vary from one provider to another over time. Finally, services are perishable and cannot be stored, as once they are consumed. This can cause difficulty in managing the supply to meet the demand over the business cycle.<sup>207</sup> In the meantime, not all services are intangible, heterogeneous, and perishable, as some manufactured goods may possess one or more of these characteristics.<sup>208</sup>

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<sup>204</sup> Zeti Akhtar Aziz, "Recent Developments in Islamic Finance in Malaysia," (Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, the Malaysian Islamic Finance Issuers and Investors Forum 2006, Kuala Lumpur, 14 August 2006)

<sup>205</sup> Ahmed, *Product Development in Islamic Banks*, 10-12.

<sup>206</sup> R. G. Cooper, C. J. Easingwood, S. Edgett, E. J. Kleinschmidt, and C. Storey, "What Distinguishes the Top Performing New Products in Financial Services," *Journal of Production Innovation Management*, 11 (1994): 281-299; Vermeulen and Raab, *Innovations and Institutions*, 36-38.

<sup>207</sup> Ulricke de Bretani, "The New Product Process in Financial Services: Strategy for Success," *International Journal of Bank Marketing* 11(1993): 15-22.

<sup>208</sup> Christopher J. Easingwood, "New Product Development for Service Companies," *Journal of Production Innovation Management* 4 (1986): 264-275.

### 2.3. Theories of Product Development

Many studies have been taken to investigate the theories and principles of product development in financial institutions including banking sector. In sum, these theories can be classified into four aspects, namely the theory, process, emergence and factor of success or failure of product development.<sup>209</sup> For the theory aspect, Booz *et al.* (1982) have classified product development into six types, namely new-to-the-world products, new product lines, product improvement, product line extensions, repositioning, and cost reductions. In the same way, Lovelock (1984) who studied the nature of services, has also divided them into six types of new services, namely major innovations, start-up businesses, new products for the currently served market, product line extensions, product improvements and style changes, which is not so different with the classification by Booz *et al.* (1982).

In addition, Ansoff (1957) introduced four matrix business strategies for product development, which are still being used by many corporate companies to strategize their corporate objectives. It is also known as Ansoff's matrix, which has four elements namely; market penetration, product development, market development, and diversification. Market penetration is a strategy that uses the same product or service and sells it in the present market, where there is no change to strategy, except that the company intensifies the effort to sell the product. Meanwhile, product development is a company develops a new product in order to sell it in the existing market. On the other hand, market development is a policy where a company uses the present product to introduce and sell it in a new market. Finally, diversification strategy deals with a total change in the market and product, where the company is required to develop a new product for introduction to a new market.<sup>210</sup>

The Ansoff's strategy delineates the technique of improving target markets through three strategies, namely new customer, new market dimension or diversification. This is done so that newly developed product can be sold in new market segments rather than in the existing market or to existing customers and thus enhancing the mix

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<sup>209</sup> Jeroen P.J. de Jong, Patrick A.M. Vermeulen, (2003), "Organizing Successful New Service Development: A Literature Review," *Management Decision* 41, no. 9 (2003):844 - 858; Axel John, Chris Storey, "New Service Development: A Review of The Literature and Annotated Bibliography," *European Journal of Marketing* 32, no. 3 (1998): 184 - 251.

<sup>210</sup> Igor Ansoff, "Strategies for Diversification," *Harvard Business Review* 35, no. 5 (Sep-Oct 1957): 113-124.



of customers served by the organization. It is also encouraged to diversify the products through improving the characteristics of the products, or to diversify the market channel of distributing the products.<sup>211</sup> Various approaches and strategies can be taken by a firm in order to develop market segments, such as capturing customers from competitor firms, to expanding the previously un-served customers in the market. This can be achieved through developing market segments that are currently being served, identifying types of customers the firm has, and categorizing customers' interests in the product. The firm needs to use cost effective strategies so they would not end up with spending more money in developing a market that they could potentially earn by simply expanding. Therefore, to maximize business opportunities, the above four elements; namely product development, product augmentation, process and market development, must be integrated and combined. As financial and banking services may easily be imitated from their counterparts, these institutions need to broaden their market segmentation through marketing strategies rather than through developing a major innovation in services that can be imitated immediately.

Johne and Storey (1998) explain that product development is an umbrella term embracing improvements and also radical alterations.<sup>212</sup> They also classified the scheme of products in a similar classification as that of Booz *et al.* (1982), but they excluded the last two types, i.e.: 'repositioning' and 'cost reduction'. They argued that these two concepts are not part of the process of new product development and have distinct types of approaches in their own right, which differ from the features of product development that they mean. 'Repositioning' means making changes to the way of the core product features are promoted and made available to customers. This is also known as "product augmentation." Augmentation engages changes in the delivery system and supplier's support to the customers, which do not directly engage with the main features of the product.<sup>213</sup> Additionally, this is also similar to cost reduction, where there is no change made to the structure of the actual product. Both approaches involve the external features of the product, namely delivery system, promotion, support system, marketing, and cost reduction, instead of the internal design or the struc-

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<sup>211</sup> Johne and Storey, "New Service Development," 192.

<sup>212</sup> *Ibid.*, 84-251.

<sup>213</sup> C.J. Easingwood and C.D. Storey, "Marketplace Success Factors for New Financial Services," *Journal of Services Marketing* 11, no. 3 (1993):35-43; A. Johne and P. Pavlidis, "How Banks Apply Marketing Expertise to Develop New Derivatives," *Journal of Product Innovation Management* 13, no. 5 (1996):440-452.

ture of the product itself. Product development meant by the authors is a massive alteration, or improvement, or modification made on the structure, of the product.

The second element in product development deals with the process in creating a new product. It is a blend of multifaceted activities, which involves several stages and steps and various departments and units within the firm. The process of product development in financial industry comprises of the activities and the distribution of responsibilities among relevant personnel to develop a new product. Theoretically, these processes are exercised in a sequence of activities, which starts from idea generation and ends with commercialization, but most institutions do not necessarily follow these activities, step by step. Sometimes, they also need to repeat the same process and different banks have different situations, which makes them flexible with the process. Nonetheless, a vital aspect of this process is to have a well-planned scheme that details the various phases and steps within each phase, in order to ensure the whole process progresses timely and ends successfully.<sup>214</sup> This scheme acts as a roadmap to develop a new product. A well-planned process will benefit the firm in a few aspects; introducing discipline, reducing technical risk and completion of tasks by a cross-functional team. Moreover, elements in the product development process determine the execution time and the performance of the product after launch.<sup>215</sup> It has been evidenced that financial institutions have rigorous product development processes and are likely to produce successful products.<sup>216</sup>

On the other hand, different scholars have suggested other aspects of the process of product development. For example, Johnne and Harborne (1985) who studied specifically product innovation in banks, suggest three main phases of the product development process; initiation, evaluation and implementation.<sup>217</sup> Cooper (1990) on the other hand, popularized the concept of stage-gate process, where the product development process goes through different phases and checkpoints or gates. At each gate, the product is assessed by a relevant authority and decision of 'go/kill/hold/recycle' is made. The objective of having checkpoints after each development phase is to reduce

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<sup>214</sup> Ahmed, *Product Development in Islamic banks*, 106.

<sup>215</sup> Robert G. Cooper, "Perspective: Third Generation New Product Development Process," *Journal of Product Innovation Management* 11 (1994):3-14.

<sup>216</sup> Scott J. Edgett, "The New Product Development Process for Commercial Financial Services," *Industrial Marketing Management* 25 (1996):507-515.

<sup>217</sup> F. Axel Johnne and P. Harborne, "How Large Commercial Banks Manage Product Innovation," *International Journal of Bank Marketing* 3 (1985): 54-71.

the probability of failure. By screening good ideas and products, a firm can reduce the costs of failed products.<sup>218</sup> Meanwhile, Cooper (1994) who investigates the product development in general conception identifies four stages; preliminary investigation, building a business case, development, and test and validation.<sup>219</sup> Avlonities *et. al* (2001) suggests five activities; namely idea generation and screening, business analysis and marketing strategy, technical development, testing, and commercialization/launching.<sup>220</sup>

The third element examined in product development is the factors that contribute to the emergence of new financial product. Silber (1977) argues that constraints-induced, such as self-imposed (organization rules), market-imposed (external forces) or government-imposed (regulator) are identified as drivers to product development.<sup>221</sup> Kane (1981) explains that processes and responses towards regulations are part of a cyclical interaction between political and economic forces, which also influence product innovation in financial institutions.<sup>222</sup> Miller (1986) claims that the emergence of financial innovation in the United States since 1960s because to reduce regulations and taxes.<sup>223</sup> Merton (1992) asserts that financial innovation has six purposes for its development; namely to mobilize funds across time and space, pool funds, manage risk, extract information in supporting decision-making, address moral hazard and asymmetric information problems, and finally facilitate sale or purchase of goods through payment.<sup>224</sup> Tufano (2002) elaborates that financial innovations emerged because of market incompleteness, agency concerns and information asymmetries, minimizing transaction, marketing costs, respond to taxes and regulation, increasing globalization and risks, and technological shocks.<sup>225</sup> Some scholars seem to suggest factors that are close with each other, are completely different from their counterparts. Their findings enhanced the understanding of why a product developed from different perspective. They also may

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<sup>218</sup> Robert G. Cooper, "Stage-Gate Systems: A New Tool for Managing New Product," *Business Horizons*, (May-June 1990): 44-53.

<sup>219</sup> Cooper, "Perspective: Third Generation New Product Development Process," 3-14.

<sup>220</sup> Avlonitis *et. al.*, "An Empirically-Based Typology of Product Innovativeness," 324-342.

<sup>221</sup> William L. Silber, "The Process of Financial Innovation," *The American Economic Review* 73, no. 2 (May 1983): 89-95.

<sup>222</sup> E.J. Kane, "Impact of Regulation on Economic Behaviour," *The Journal of Finance* 36, no. 2 (May, (1981):355-367.

<sup>223</sup> Miller, "Financial Innovation," 459-471.

<sup>224</sup> R.C. Merton, "Financial Innovation and Economic Performance," *Journal of Applied Corporate Finance* 4, no. 4 (1992):12-22.

<sup>225</sup> Tufano, "Financial Innovation," 308-331.

guide the directions, management and the processes of product development which are undertaken in a well-organized manner, considering these factors.<sup>226</sup>

Finally, the study of product development also examines the factors contribute to the success and failure of products as well as top performers from lower performers in product development.<sup>227</sup> Cooper *et. al.* (1994) found that the success of product development depends on not only a perfect execution of activities in product development, but also the supporting activities. The supporting activities include opportunity analysis, project development, and offer formulation. Opportunity analysis concerns the importance of synergy between the new product and the firm strategy. It also involves the available resources, expertise and market opportunity.<sup>228</sup> Meanwhile, project development is a formalized process within the firm that manages the functional coordination between the departments involved in the process (e.g. IT and marketing department). It also involves the use of customer contact personnel in the development process, top management support, speed of development, testing and a well prepared formal launch. Finally, offer formulation is concerned with the features of the services, or in other words, the additional services that support the product. Most of these processes are undertaken to fulfil the requirements and ensure the satisfaction of the customers.<sup>229</sup>

Another element that leads a product's success in the market place is the way a product is delivered to the customer or a customer is served by the institution providing the service or product.<sup>230</sup> It is emphasized that the expert and professional role of the front-line personnel in explaining the services offered by the institutions is very important. Such skill includes the ability to explain the features, advantages, and benefits of the product and the ability to deliver high quality of service in an enthusiastic means to the customer, are very essential to impress customers.<sup>231</sup> A good first impression of the customers may result in repetitive consumption of the services and they might go back to the same premises for similar services. Customer's participation and customer's feedback to the delivery of products and other services are important for the firm to improve their service and to make adjustments and changes to the previous services that have shortcomings based on the feedback given by the customers. Recently, there has

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<sup>226</sup> Ibid.

<sup>227</sup> Cooper and De Bretani, "New Industrial Financial Services, 75-70.

<sup>228</sup> Cooper, Easingwood, Edgett, Kleinschmidt, and Storey, "What Distinguishes," 281-299.

<sup>229</sup> Johne and Storey, "New Service Development," 84-251.

<sup>230</sup> Vermeulen and Raab, *Innovations and Institutions*, 43.

<sup>231</sup> Cooper, Easingwood, Edgett, Kleinschmidt, and Storey, "What Distinguishes," 281-299.

been a study on the financial industry, which reported that the lack of attention to customers contributes to the failure of the product offered by the financial institution. Therefore, it is necessary for the firm to emphasize on customers' service including attention, behavior, attitude, requirement, and satisfaction of customers to increase its sale and profits.<sup>232</sup>

## 2.4. Product Development and Innovation

Product development and innovation are inseparable. Innovation is a process of interrelated activities that consumes an enormous amount of time, energy, and financial investment. Firms persistently search for optimal means of managing their innovation processes.<sup>233</sup> Innovation is derived from the verb “innovate,” of the Latin root, “novus”, which means new. It refers to a new idea, method, device or the process of introducing something new, which constitutes two elements, namely product and process.<sup>234</sup> Product refers a new derivative of a product or new corporate security. Meanwhile, process refers to the improvements epitomized by the new means of distributing securities, processing transactions or pricing transactions. In this respect, the innovation process is nothing novel, as there is a difficulty in discerning the phenomenon particularly the degree of newness or novelty in every product. In practice, the difference of both terms is not clear, as product and process innovation is often interwoven. For example, the processes of promoting a new index linked to a college cash flow with the aim of producing returns to help parents save to fund their children's educational cost, is hard to be separated from a new indexed investment product, namely a new derivative product, which employs this index as underlying asset.<sup>235</sup>

The emergence of financial innovation is not merely a matter of chance. This can be evident that many financial innovations have existed quietly in the market for many years before they became prominent. The product has undergone the gradual pro-

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<sup>232</sup> Vermeulen and Raab, *Innovations and Institutions*, 44.

<sup>233</sup> Vermeulen and Raab, *Innovations and Institutions*, 5.

<sup>234</sup> Peter Tufano, “Financial Innovation,” in *the Handbook of the Economics of Finance*, edited by George Constantinides, Milt Harris And René Stulz (Amsterdam: Elsevier, 2003), vol. 1A, 308-331; Shanthi Gopalakrishnan and Fariborz Damanpour, “Patterns of Generation and Adoption of Innovation in Organizations: Contingency Models of Innovation Attributes,” *Journal of Engineering and Technology Management* 11, no. 2 (June 1994): 95–116.

<sup>235</sup> Tufano, “Financial Innovation,” 308-331.

cess of modification, alteration and improvement, which is also known as innovation spiral.<sup>236</sup> Once a product is created, there will be always and continuously a room for improvement and further innovation.<sup>237</sup> Innovation is generally a firm's response and adaption to the changing conditions of the markets and the environments. In a marketplace that is constantly evolving, firms that do not innovate and come up with new products can eventually weaken and die.<sup>238</sup>

The innovation process does not 'unfold in a simple linear sequence of stages and sub-stages' thus firms have to be very flexible in their management. Instead, it expands into complex bundles of innovative ideas and divergent paths of activities by different organizational units.<sup>239</sup> Financial firms will also follow a similar path of innovation processes such as the process of signal processing, strategic concept, product and market development, and launching. However, sometimes the same processes will be repeated to ensure their successful implementation according to the firm's objectives.<sup>240</sup>

## 2.5. Conceptualizing Product Development in Islamic Banking

Scholars have given many definitions about the concept of product development in Islamic banking from various perspectives. Noman (2002) for example explains that product development is an effort of Islamic banks to exploit Sharī'ah -compliant new ideas and possibilities in order to meet the increasing customers' demands and requirements. This new product is offered to ensure the value-added of the assets or funds invested by the customer, to sustain growth and profitability of the bank. The definition provided by the author seems to be similar to the conventional framework; however, he attempts to differentiate product development in conventional from Islamic banking

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<sup>236</sup> M.H. Miller, "Financial Innovation: The Last Twenty Years and the Next," *Journal of Financial and Quantitative Analysis* 21, no. 4 (1986):459-471.

<sup>237</sup> Tufano, "Financial Innovation," 308-331.

<sup>237</sup> Gordon Fuller, *New Food Product Development: From Concept to Marketplace* (Boca Raton, FL: CRC Press LLC, 2005), 308-331.

<sup>238</sup> Fuller, *New Food Product Development*, 1.

<sup>239</sup> Andrew H Van De Ven, "Managing the Process of Organizational Innovation," in *Organizational Change and Redesign, Ideas and Insights for Improving Performance*, edited by Huber G.P. and Glick W.H. (New York: Oxford University Press), 259-304; Patrick Vermeulen and Jorg Raab, *Innovations and Institutions: An Institutional Perspective on the Innovative Efforts of Banks and Insurance Companies* (Abingdon: Routledge, 2007), 5.

<sup>240</sup> J. Bessant J. Tidd, and K. Pavitt, *Managing Innovation: Integrating Technological, Market and Organizational Change* (Chichester: Wiley, 1997), 70.

through the Sharī'ah values which are embedded throughout the product.<sup>241</sup> In the same vein, Ayub (2007) explains product development as the process of developing assets through innovation and research to cater to the customers' demands in the most suitable way within the parameters of the Sharī'ah governing and legal boundaries. He also includes the process of reengineering the existing products in accordance with the Islamic economic principles and the changing requirements of the businesses.<sup>242</sup> He attempts to associate that product development should be based on Sharī'ah law and to uphold the moral and ethical principles.

Meanwhile, Bakar (2008) tends to regard that product development is a part of *fiqh* discipline, as most Islamic banking products developed must be based on the Sharī'ah contracts. It is an essential exercise to create a new product or instrument to meet specific requirements, consumers, regulators, industry, or all of these entities. He opines that the approach adopted by Islamic banking is different from conventional banking where, from his personal observation, he regards that conventional banking products are more focused on product enhancement. This is due to the fact, that all the financing and deposit products are simply based on the loan contracts. Conventional product tends to add some new features to the existing products and describe them as a new product. However, this is not the case in Islamic banking products, as new product must fundamentally be based on a new concept or contract otherwise, it is just considered product enhancement.<sup>243</sup> Unfortunately, he did not give some examples for further elaboration on these distinctions. A question can be raised, for example, to what extent the new concept is developed in Islamic banking different from conventional banking. This is an important question because it has been argued that there is not much difference between Islamic and conventional products, for example, a contract that is based on *murābahah* concept is only different in form but the substances and elements embedded into the product are conventional materials, such as pricing and benchmark.<sup>244</sup>

Iqbal and Mirarkhor (2007) opine that product development or financial engineering refers to the design and development of innovative financial instruments and

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<sup>241</sup> Abdullah M. Noman, "Imperatives of Financial Innovation for Islamic Banks," *International Journal Of Islamic Financial Services* 4, no. 3 (Oct-Dec 2002): 1-10.

<sup>242</sup> Muḥammad Ayub, *Understanding Islamic Finance* (N.J.: John Wiley and Sons, 2007), 358.

<sup>243</sup> Mohd Daud Bakar, "Sharī'ah Approaches to Product Development and Product Enhancement in Islamic Banking and Finance," in *Essential Reading in Islamic Finance*, edited by Mohd Daud Bakar and Engku Rabiah Adawiyah Engku Ali (Kuala Lumpur: CERT, 2008), 124.

<sup>244</sup> Salma Sairailly, "Murābahah Financing: Some Controversial Issues," *Review of Islamic Economics* 12 (2002): 73-86.

processes as well as the search for creative solutions to problems in finance. This process may lead to a new consumer-customized financial instrument, or a new security, or a new process that ultimately results in reducing costs of funds, increasing return on investment and/ or expanding opportunities for risk sharing.<sup>245</sup> Nonetheless, the definition given by the authors is not much different from the conventional context which attempts to utilize different methods and techniques in the fields of computer science, statistics, economics and applied mathematics to devise novel and innovative financial products. It also refers sometimes to quantitative analysis, which is regularly used by commercial banks and insurance companies.<sup>246</sup>

Meanwhile, there is a recent concept of product development in Islamic banking that it should be classified into two divisions, namely Sharī'ah-based and Sharī'ah-compliant products. Ahmed (2011) defines Sharī'ah-compliant products, as those that only satisfy the form (requirements of contract) and substance (real objectives of the contract) of Islamic law but fail to fulfil the objectives of the social goals. While Sharī'ah-based are the products that fulfill all the requirements of form and substance of Sharī'ah and the financial need of populace, including the poor and small micro enterprises. Furthermore, he adds another classification which is pseudo-Islamic products that fulfil the forms but not the substance of Sharī'ah and the social needs. Commonly the products are structured by using *ḥilah* (ruses) to circumvent the prohibition of *ribā* and *gharar* in Sharī'ah.<sup>247</sup>

On the other hand, Lahsasna and Hassan (2011) assert that Sharī'ah-based products are derived from the contracts which are based on the Qur'ān and the Sunnah (primary sources) and other sources of Sharī'ah (secondary sources). The lists of these contracts have been deliberated by Muslim scholars through ages such as *muḍārabah*, *musharakah*, *salam*, *ijārah*, and *hiwālah*. Meanwhile, the latter products are from conventional finance products and then were converted into Islamic products due to their importance to the market.<sup>248</sup> In this regard, they contend that the restructuring of former products will not change their nature and criteria. The same contract rules apply regardless of the development of the contract in the different application in Islamic banking and finance. For example, the contract of *salam* has been developed into parallel for-

<sup>245</sup> Iqbal and Mirarkhor, *An Introduction of Islamic Finance*, 203.

<sup>246</sup> Investopedia, "Financial Engineering," accessed on 20 May 2013, <http://www.investopedia.com/terms/f/financialengineering.asp>

<sup>247</sup> Ahmed, *Product Development in Islamic Banks*, 167-168.

<sup>248</sup> Lahsasna and Hassan, "The Sharī'ah Process," 37-39.



ward sale (*salam mawāzī*) and used in banking and Islamic capital markets, but the said development in the *salam* contract will not release it from the basic rules that govern the contract of *salam*. On the other hand, one example of Sharī'ah-compliant product is that cross-currency swap product is structured by using two simultaneous *murabaha* transactions, (a term and reverse *murabahah*, are used to generate cash flows similar to a conventional currency swap of conventional derivatives products).

Notwithstanding, Dar (2009) has divided Islamic banking products into three categories. First category is a product that fulfils the requirement of public interest based on the objectives of Sharī'ah. This effort can be undertaken through public's preference ordering of *Maqāṣid al-Sharī'ah* (essentials, necessities and luxuries). In other words, product that fulfil the essentials should be preferred than necessities or luxuries which can be implemented through public policy of government. Second category is the fulfilment of normal required contracts (pillars and stipulations of contract) and avoidance of Sharī'ah prohibitions (*ribā*, *gharar*, *maysir* and etc.). Thus, any product that gives access to liquidity and cash to customer such as fixed return either in the form of *murābaḥah* or *ijārah* by exchanging fictitious commodity or artificial items can be categorized as Sharī'ah-compliant product, if not merely Sharī'ah tolerated. However, such product is undesirable by the proponents of Sharī'ah based-product as they argued the product only fulfil the external form and not the internal substance of economic transactions. Third category is economic criteria, which focus on the pricing issue whereby it implies that Islamic bank should offer lower price of product than conventional banking. However, this category is also less desired by Sharī'ah advisor and even Islamic bankers because it does not differ much from the second criteria that emphasizes only on aspect of the characteristics.<sup>249</sup>

In contrast, Laldin (2009) contends that there is no difference between the two approaches. A product is considered as Islamic as long as the product in line with Sharī'ah rules. The demarcation is unimportant but the impact of the product to generate real transaction and the growth of economy is essential. When a product is developed, the aspect of micro and macro perspectives of Sharī'ah aspects must be observed in order to see the good implication of the product in the economic and social sphere.

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<sup>249</sup> Humayon Dar, "At the Crossroad," *New Horizon*, July-September 2009, 10-12, accessed on 8 March 2012, [http://www.islamic-banking.com/resources/7/NewHorizon%20Previous%20Issues/NewHorizon\\_JulySep09.pdf](http://www.islamic-banking.com/resources/7/NewHorizon%20Previous%20Issues/NewHorizon_JulySep09.pdf).

Thus, creativity and innovation play important role in Islamic banking to create a product that conform to the theoretical and practical aspect.<sup>250</sup>

In this respect, there is no standard or a general concept of product development in Islamic banking agreed by scholars. Some of the elaborations tend to focus only on a narrow understanding of the issues surrounding product development, which circulates and emphasizes mostly on the legal perspective or *fiqh* that is related to the normative standards in designing Islamic banking products. This approach is quite different from the conventional approach which relies on scientific research that collects data from the field and makes conclusions of what is the product that is appropriate for introduction to the market.

Nevertheless, the main point that the scholars agree on is that product developers must ensure every process undertaken is consistent with the faith of Muslims, ethical codes (*akhlāq*) and the rules of Sharī'ah. The demarcation between conventional and Islamic bank's product development is oriented on the religious values upheld by the latter. The conventional banking solely seeks profitability without associating with religious values, whereas the Islamic banking seeks profitability, but only through a set of religious law of Sharī'ah. In order to ascertain the compliance of the banks towards the rules, Islamic banks have to follow strictly the Sharī'ah principles proposed by their Sharī'ah advisory council, which has a task to issue Sharī'ah decisions, monitor and review the operation of the banks.<sup>251</sup> Nonetheless, it seems that the concept, types of products, rationales, factors of success and failure, as well as processes of product development of Islamic banking products are similar to conventional product development.<sup>252</sup>

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<sup>250</sup> Muḥammad Akram Laldin, "Sharī'ah Compliant versus Sharī'ah-Based Product: What it is?" *ISRA Bulletin*, vol. 2, April 2009, 2; see also Umer Chapra, "Innovation and Authenticity in Islamic Finance," (Forum Speech at Eighth Harvard University Forum on Islamic Finance: Innovation and Authenticity, 19-20 April 2008); Gillian Rice, "Integrating Quality Management, Creativity and Innovation in Islamic Banks," (paper prepared for presentation at the American Finance House - Lariba 8th Annual International Conference, Pasadena, CA, 16 June, 2001).

<sup>251</sup> Ahmed, *Product Development in Islamic Banks*, 9; Chapra, "Innovation and Authenticity in Islamic Finance."; Habib Ahmed, "Defining Ethics in Islamic Finance: Looking Beyond Legality," (paper presented at 8<sup>th</sup> International Conference on Islamic Economics and Finance, Doha, Qatar, December 19-21, 2011).

<sup>252</sup> Hafas Furqani and Mohamed Aslam Haneef, "Methodology of Islamic Economics: Typology of Current Practices, Evaluation and Way Forward," (paper presented at 8th International Conference on Islamic Economics and Finance, Doha, Qatar, December 25-27 2011); see also Chapra, "Innovation and Authenticity in Islamic Finance."

## 2.6. Principles in Developing Sharī'ah-Compliant Products

### 2.6.1. Sharī'ah requirements

As stated previously, product development in Islamic banking is formulated under a set of religious law of Sharī'ah. The primary concern of developing a Sharī'ah-compliant product is that the product must satisfy all of the Sharī'ah requirements, which refer to the prerequisites required for Islamic banking products to observe including the fulfilment of the pillars and the conditions of contracts and avoidance of prohibited elements such as, *ribā*, *gharar*, and *maysir*.<sup>253</sup> The fulfilment of contract's pillars and conditions includes the subject matter must be qualified and recognized by the Sharī'ah, the clearly spelt out expression of offer and acceptance, and an eligible contracting party who is acknowledged by the Sharī'ah. In order to declare a product is valid, there is no need to search for affirmative evidence from the textual sources. The approach that can be applied by the jurists is only to search for the existence of a clear, self-explanatory prohibition, if it does not exist, then the contract or product is regarded as valid. Furthermore, the Qur'ān or the Sunnah also does not exhaustively delineate the lists of validated transactions, contracts or trades, and when the sources do not address any legal rulings of new transactions, it could be presumed that the transactions assumed are permissible.<sup>254</sup> Hence, for any new products created, there is no need to search for supportive proofs or evidences from the Qur'ān or the Sunnah or views and precedents from the early jurists, because they are generally permissible.

It is also important to ensure that all the principles, rulings, legal consequences of the contracts must be applied consistently. In other words, contractual forms must serve the substance of the contracts, or means must serve the ends. In sale contract, for example, among its legal principle is that the seller should transfer the ownership to the buyer, whereby the buyer must render the price or consideration to the seller, as agreed. If there is legal restriction or stipulation that the contract could not serve the transfera-

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<sup>253</sup> S. A. Rayner, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to Modern Legislation in Kuwait, Bahrain and the U. A. E* (London: Graham and Trotman, 1991), 174-258.

<sup>254</sup> The Qur'ān has emphasized many verses such as in the Sūrah al-Jāthiyah; 45:13, "and He has subjected to you from Him, all that is in the Heavens and on Earth. Behold, in that are Signs indeed for those who reflect." Other verses see Sūrah al-'An'ām:145, 119.

bility of the ownership or the objective of sale contract, then the contract is considered as null and void.

### 2.6.2. Risk taking, risk sharing and risk transfer

Risk taking refers to the concept that any profit or return of Islamic banking activity must be obtained through the risk undertaken by the bank. Any profit or return without engaging any risk would be invalid and deem the product or service as being non-Sharī'ah-compliant products. This is known as *al-kharaj bi ḍaman* (the entitlement of profits is due to the risk undertaken) and *al-ghunm bi al-ghurm* (returns are justified by taking risks). This can be illustrated as selling something that is not in possession of the seller, is prohibited, unless the asset is obtained before its sale. Providing a loan facility by charging some benefits or increase in the principal on the loan from the borrower is considered null and void, since the profit or benefit obtained is not based on the risk taken. However, Islamic bank is also not allowed to develop a product that is based on excessive risk taking, such as involvement in gambling or speculative activities in the stock market or derivatives of the market, as it is equivalent to the *gharar* and *maysir* elements.

Meanwhile, the concept of risk sharing means that the Islamic bank is encouraged to develop a product that is based on joined risks, such as in partnership, since it encourages cooperation and responsibility among the parties involved, in realizing the profits and the returns. The profit is more justified as every party bears the risk. Nonetheless, the concept of risk sharing is not preferable since the nature of risk sharing is very risky and hazardous to the banking activity. Problems, such as asymmetric information, moral hazard, and adverse selection are among the issues faced by risk sharing instruments.

As a result, it is preferred that the Islamic bank transfers the risk and this practice is also known as risk mitigation. It refers to the attempt that the bank undertakes to relocate or remove partially or totally the risks assumed to the other party, i.e. customer or *takāful* company.<sup>255</sup> Many Islamic banking instruments used to transfer the risk such

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<sup>255</sup> See classical risk transfer instruments used to mitigate risks in Rania Abdelfattah Salem, *Risk Management for Islamic Banks* (Edinburgh: Edinburgh University Press, 2013), 102.

as *salam*, *kafālah*, *rahn*, security money (*hamish jiddiyah*), *‘urbūn* (earnest money) or third party guarantee as mediums for transferring and mitigating risks.

### 2.6.3. Permissibility and freedom of contract

In developing products, Islamic bank also must be concerned with honoring the rights and obligations towards the contractual undertaking. This is asserted in the Qur’ān that God instructs to trade amongst people in good mutual undertaking (the Qur’ān, 4:29) and to fulfil obligations agreed upon as stipulated in the contract (The Qur’ān, 5:1).<sup>256</sup> This is known in the modern context as a freedom to form a contract, which is probably different from the western paradigm of freedom of contract. The western conception of freedom of contract emphasizes the degree of freedom to the contracting parties to determine independently and without any restrictions the terms and objects of their agreement, except if they are contrary to the state’s laws.<sup>257</sup> However, this is different from Islamic banking products, which must abide by the rules and the principles of the Islamic religious values.

Historically, the concept of freedom of contract was not emphasized by the classical jurists; however, it became a critical subject due to the influx of western influence since their increasing influence in the 18<sup>th</sup> century. Prior to that, most of the classical scholars only discussed the concept, which circulates around the permissibility of inserting certain terms and conditions into the contracts. They hardly discussed the possibility of formulating any new contract. If there was a new contract that emerged, they tended to include the new contract under the nominated contracts, such as sale, leasing, partnership, and forward sale. Muslim scholars also do not discuss the general concept of contracts in the same manner of the western style, since there was no need to formulate the general theory of contract.<sup>258</sup> This is because, at that particular time, the jurists were comfortable to elaborate the rules of contracts based on the cases or casuistry ba-

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<sup>256</sup> Rayner, *The Theory of Contracts in Islamic Law*, 91; Nabil Saleh, “Freedom of Contract: What Does it Mean in the Context of Arab Laws?” *Arab Law Quarterly* 16 (2001): 346-47; Mohammed Obaidullah, “Ethics and Efficiency in Islamic Stock Markets,” *International Journal of Islamic Financial Services* 3, no. 2 (2001): 1-10.

<sup>257</sup> Rayner, *The Theory of Islamic Law of Contract*, 91.

<sup>258</sup> Vogel and Samuel, *Islamic Law and Finance*, 99

sis.<sup>259</sup> According to Vogel and Samuel (1998), they argue that new contracts can survive if the new form combines various established nominated contracts recognized by the classical scholars in a single name or to form a more complicated application of standard contractual relationship.<sup>260</sup>

Concerning the permissibility of inserting certain stipulations in the contract, that has divided Muslim jurists into two factions. First, the opposition camp comprises mainly of the Ḥanafīs, Shāfi'īs and Zāhirīs. They strongly oppose any stipulations being inserted, except conditions that are in line with the legal requirements and consequences of the contracts (*muqtaḍā al-'aqd*), whereas the Ḥanbalīs and Mālikīs are very flexible in accepting any stipulations, provided they are not contrary to the Qur'ān and the Sunnah.<sup>261</sup> The latter's position seems to have been accepted in the modern Islamic law, as well as in Islamic banking, which gives the Islamic banks more space to create new terms and contracts to fulfil their client's demands and requirements.

#### 2.6.4. Customary practices

Sharī'ah also recognizes the customary practices (*'urf*) or recurrent practices that are acceptable in the society, as one of the sources of Sharī'ah. It becomes a valid and pragmatic mechanism, as it is molded directly from the experience, requirements and conditions, which are prevalent in the society. *'Urf*, that are not contrary with the principles of Sharī'ah law are valid and authoritative, observed and upheld in the Sharī'ah. There are many Islamic legal maxims that address the authority of *'urf*, such as “custom is authoritative,” and “what is proven by *'urf* is based on the Shari'a proof”<sup>262</sup> The recognition of *'urf*, as part of Sharī'ah methodology, which can be observed in the Ottoman Mejelle that provides a specific proviso to *'urf*. It stated that whether public or personal may be invoked to justify the passing of judgment.<sup>263</sup> Since banking is

<sup>259</sup> Casuistry means a method that acknowledges that the validity of legal concepts is confined to certain boundaries and that one has to determine whether or not the individual case falls within these boundaries. Baber Johansen, “Casuistry between Legal Concept and Social Praxis,” *Islamic Law and Society*, 2, no. 2 (1995): 135-156.

<sup>260</sup> Ibid.

<sup>261</sup> See the conditions in Ossama Arabi, “Contract Stipulations (*shurūṭ*) in Islamic Law: The Ottoman Majalla and Ibn Taymiyya,” *International Journal of Middle East Studies* 30, no. 1 (1998): 29-50; Vogel and Samuel, *Islamic Law and Finance*, 99.

<sup>262</sup> Kamali, *Islamic Commercial Law*, 80.

<sup>263</sup> See Art. 36, The Mejelle. “Articles 1-100,” translated by C. A. Hooper. *Arab Law Quarterly* 1, no. 4 (Aug., 1986): 373-379.

currently an essential part of the society, Sharī'ah recognizes the practice as part of its system. Hence, services and products, such as, deposit taking, investment, credit cards, loans, and mortgages, are recognized as some of the needs of the community. These needs and desires must be aligned with the principles of Sharī'ah and the prohibitions explicitly dictated in the Sharī'ah, such as *ribā*, *gharar*, and *maysir*.

#### 2.6.5. Maṣlaḥah

This principle endorses that the prohibitions dictated in the Qur'ān and the Sunnah would not deter Muslims from undertaking any commercial activities. The purpose of the prohibitions imposed is to ensure that the contracting parties, involved in contractual agreement have justice and fairness in the exchange. These two principles are correlated with the principles of *maṣlaḥah* (public benefits), which promotes securing benefits and preventing harms in any transactional undertaking. Sharī'ah does acknowledge *maṣlaḥah* for the commercial activities, which are not regulated by the Lawgiver (either in the Qur'ān or the Sunnah), as long as there is no textual authority that prohibits its undertaking, which is known as *al-maṣlaḥah al-mursalah* (unrestricted public benefits) or *maṣlaḥah muṭlaqah* (absolute public benefits). There are a number of Islamic legal maxims that emphasizes that a commercial transaction must not be harmful to people. This principle was asserted in the famous Islamic legal maxim “there is no harm that shall be inflicted or reciprocated in Islam (*la darara wala dirar*)”.<sup>264</sup> This legal maxim, which is derived from a *ḥadīth*, emphasizes that it is forbidden to harm people or to reciprocate harm to other people, when one is inflicted with harm, except within the boundaries of the rule of law.

#### 2.7. Classification of Islamic Banking Products

It has been avowed that the majority of the financial instruments in the marketplace are not new instruments or revolutionary inventions, but rather they are merely fusions of older generation derivatives and/or standard cash market instruments.<sup>265</sup> As part of the international financial landscape, Islamic banking also cannot run away from

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<sup>264</sup> Muḥammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Kuala Lumpur: Ilmiah Publisher, 1998), 269.

<sup>265</sup> Warren Edwards, *Key Financial Instruments: Understanding and Innovating in the World of Derivatives* (London: Pearson Education, 2000), 8; Thomas *et. al.*, *Structuring Islamic Finance*, 6.

the fact and the products offered are parallel to the range of conventional banking products, except for those involving “interest” or are embedded with the prohibited elements. One of the reasons given is that most personnel hired in the Islamic banks are from conventional banks that are also educated and trained in the conventional methods of banking. As a result, the way that Islamic banks design their products seem similar to the conventional banks.<sup>266</sup> It has also been argued that as a result of competitive market forces and in order to realize a rapid commercialization success in the industry, it is easier to “pinch” conventional products to make them “Islamic” or “Sharī‘ah compliant” or to apply the least-complicated Islamic concepts under conventional regulations, rather than to device a new model/ product from scratch. Consequently, the approach taken by Islamic banking makes them equivalent to the conventional banking.<sup>267</sup>

The core of Islamic banking products is generally derived from trade-related financing instruments. In this respect, it means that Islamic banks may be involved directly in the business by selling and purchasing products. In contrary, the banks do not get involved directly in the business but instead they become a middle man to assist their clients to get their interested products or services through Sharī‘ah compliant ways. Normally, Islamic banking products offered in the market could be divided into three types of products and services: consumer, corporate and wealth management products.

Under consumer products, Islamic banks normally offer products that are similarly offered by conventional banks, such as saving and investment accounts, credit card facilities and financing facilities. These products are considered as a liability to the banks and are kept in the liability side in the balance sheet of the bank. This is because they are required to keep safe the deposits taken from their clients or to act as trustee to the fund given, which will be invested in selected investments and projects. Sharī‘ah contracts used to structure such products that are characterized as safekeeping and trust contracts, which are included: *rahn*, *wadī‘ah*, *mushārah* (active partnership), *muḍārah*, and *wakālah* (agency). Besides, Islamic banks also offer credit card and financing facilities, which attempt to facilitate for their clients of acquiring some goods or services that they would not have been able to directly purchase at a particular of time, due to cash constraint. These products typically use Sharī‘ah contracts that cater

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<sup>266</sup> Thomas, *et al.*, *Structuring Islamic Finance*, 7

<sup>267</sup> Ibid.



to debt instruments, such as *murābahah*, *tawarrūq*, *salam*, *istiṣnā'*, *mushārahah mutanāqishah* (diminishing partnership), and *ijārah*.

Besides, Islamic banks offer products to cater to the commercial sector - profit and non-profit organizations, and large entities, which may include government agencies, companies, institutions, organizations, societies, groups, and unions. The product line offered is similar to the range available for the consumer, but the banks diversify their services, to include deposit taking, trade financing, working capital, term financing, and government or special funds. Similarly, the same Sharī'ah contracts as above are adopted to structure the product. For example, for deposit taking, the contracts utilized cater to safekeeping or trust, such as *wadī'ah* or *murābahah*, while for trade financing, contracts that have a nature of sales contracts are used, such as sale and lease.

Furthermore, Islamic banks also offer wealth management products to clients who have surplus funds. The aim of this group is to expand their wealth and return on the capital in accordance with Sharī'ah principles. The products are typically developed based on the needs and requirements of their clients, who have different risk appetites, to assist them in increasing their return and yield objectives through various instruments of investment solutions. It depends on their clients' goals; either short or long term returns, capital growth or fixed income, Islamic banks will invest the funds through various mechanisms and instruments such as equities, commodities, and derivatives that comply with the Sharī'ah principles. In this regard, most Sharī'ah contracts employed stem from the type of trust, such as *muḍārabah*, *mushārahah*, and *wakālah*, and sometime most of these contracts are combined with other elements such as *wa'd* (unilateral undertaking), *'urbūn* (security money) and others to accommodate modern requirements.

## **2.8. Requirements of Islamic Banking Products**

In the process of developing Islamic banking products, appropriate product requirements must be taken into consideration by the product developers in order to ensure that the products developed are in tandem with the modern requirements of banking. Hence, some of the essential requirements include: customer requirements, pricing mechanism, ownership, risk management, and product features. Besides Sharī'ah requirements, these elements are very important for the purpose to accommodate the

modern complex needs of banking features needed by the clients. This section will briefly discuss these necessary requirements in developing Islamic banking products.

### **2.8.1. Customer needs**

Banking is a customer service provider. Customers can be divided into various categories and sectors, through the process of market segmentation. It can be defined as viewing and dividing a heterogeneous market into a number of smaller homogenous markets, according to their differing preferences. This helps the bank to precisely cater to their varying wants.<sup>268</sup> The purpose of market segmentation is to increase customer satisfaction based on a better understanding of what the customers need and want. Effective segmentation can lead to better resource allocation, better identification of market opportunities, and better marketing strategies. It is very important not only for all segments of business but it is also practical for the Islamic financial services and Islamic banking. As competition in financial services markets has increased, companies have increasingly adopted segmentation strategies in order to identify customer groups whose needs they hope to meet more closely than their competitors.

The most widely used approach in financial services segmentation is priori segmentation using demographic variables, such as age, life cycle of household and social class. For example, in lifecycle of household, products offered will be determined through the ages of the household. At the age of young executive/professionals, for instance, appropriate products to be offered to them is Islamic credit cards and house financing, since these items are necessary for them as young executives. By using these variables, differences in the customer segments in terms of behavior can be identified. In addition to the demographic approach, psychographic segmentation or benefit segmentation is also used. In psychographic segmentation, developers try to determine the expectations, attitudes, motives, and interests that customers have towards financial products and services. In benefit segmentation, potential customers are grouped according to their desired or expected utility from consuming a product or service.<sup>269</sup>

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<sup>268</sup> W.R. Smith, "Product Differentiation and Market Segmentation as Alternative Marketing Strategies," *Journal of Bank Marketing* 21 (July 1956): 3-8.

<sup>269</sup> Thomas Foscht, Cesar Maloles III, Judith Schloffer, Swee-Lim Chia and Indrajit "Jay" Sinha, "Banking on the Youth: the Case for Finer Segmentation of the Youth Market," *Young Consumers* 11, no. 4 (2010): 264-276.

### 2.8.2. Pricing

Price is an amount of money given to compensate something exchanged by two parties, for example in sale transaction, where a buyer renders a price in exchange of an item by the seller. In Sharī'ah, there is no limit to the amount of money for a seller to charge the price of an item, as long as the transaction is made in accordance to the principles of Sharī'ah, such as the exchange is done in mutual understanding and there is no *gharar* and *ribā* in the transaction. It is also acceptable in the Sharī'ah for the contracting parties to defer the payment of money in deferred transaction, but not both; the subject matter and price.<sup>270</sup> It is allowed that the credit price is higher than the spot price due to the time factor which is involved in determining the value of the contracted item. However, this is not allowed in exchanging money for money, since it will trigger the issue of *ribā al-faḍl*.

At present, the mechanisms to calculate and determine the price and the profit rate of Islamic banking products, either sales-based or leased financing, are basically benchmarked to the market interest rate such as Base Lending Rate (BLR), Kuala Lumpur Interbank Offered Rate, Overnight Policy Rate (OPR) and LIBOR. This has raised criticisms among the opponents of Islamic banking that their products do not differ from conventional products. As the components of Islamic banking pricing are the same as conventional banking, therefore the elements of cost of funds, operating cost, credit risk, and collateral property risk are taken into consideration in pricing Islamic banking products. Even, the output of the product is also the same, which is a debt on a customer equal to the sum of money he needed to purchase the item plus financing that is charged exceeding the bank's cost of fund.<sup>271</sup> Usmani (1998) urges that Islamic banks should get rid of the interest-based benchmark as the bench mark is undesirable and does not support the philosophy of Islamic economy that is interest free.<sup>272</sup>

There are many studies have been done to find an alternative to the market interest rate, for an Islamic pricing benchmark. One of the studies is made by the Interna-

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<sup>270</sup> If both counter-values are deferred, then the transaction falls under the conundrum of *bay' al-kālī bi al-kālī*, which is prohibited by the Prophet. See further the derivation of the *ḥadīth* and discussion by Muḥammad al-Bashir Muḥammad al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets* (Leiden, Boston: Brill, 2008), 174.

<sup>271</sup> Asyraf Wajdi Dusuki and Nurdianawati Irwani Abdullah, *Fundamentals of Islamic Banking* (Kuala Lumpur: IBFIM, 2011), 216.

<sup>272</sup> Muḥammad Taqī Usmani, *An Introduction to Islamic Finance*, (Pakistan: Maktaba Ma'ariful Qur'ān, 2005), 120.

tional Shari'ah Research Academy (ISRA), where the academy has produced a paper entitled "Islamic Pricing Benchmark. In this study, the group of the researchers has proposed that a pricing system that is based from the underlying asset.<sup>273</sup> However, the proposal has been rejected by the practitioners of Malaysian Islamic banks because it is very difficult to run two policies within one banking system in Malaysia. It is argued that the model is suitable for private equity ventures and not the banking industry.<sup>274</sup>

### 2.8.3. Property and ownership

Property and ownership in Islamic banking is essentially important, since the Islamic banks deal with the exchange of property from one to another party. This is different from conventional banks that do not deal with property and ownership; instead it only deals with the exchange of money with money. Money in Shari'ah is treated as a medium of transaction and its functions are to enable trade and business, standard of value, unit of account and store of value. Meanwhile, property in Shari'ah is defined as something, which can be benefited, exchangeable, and the destructor of it should be liable to pay compensation.<sup>275</sup> Property can be divided into four categories. The first category is valuable (*māl al-mutaqawwīm*), such as land, and building, and valueless property (*mal ghayr al-mutaqawwim*) such as pork, and wine, which concerns the type of property that Muslim could benefit from. The second type of property is fungible (*mithl*) and non-fungible (*qīmī*), the former refers to replaceable property while the latter refers to those that are not replaceable. The third type of property is moveable (*manqul*), such as car, book, and shoe, and immovable (*aqar*), such as building, road, or house. This type refers to property which could be transferred from one place to another and those that could not be relocated, respectively. Finally, property also can be divided into perishable, thing which perishes by consumption, like food items and non-

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<sup>273</sup> Mohd Azmi Omar, Azman Md Noor and Ahamed Kameel Mydin Meera, "Islamic Pricing Benchmark," 1-80, (ISRA Research Paper no.17/2010, International Shari'ah Research Academy, 2010)

<sup>274</sup> Emirates 24, "Bankers dismiss Islamic pricing benchmark plan," <http://www.emirates247.com/eb247/banking-finance/islamic-finance/bankers-dismiss-islamic-pricing-benchmark-plan-2010-06-03-1.251155>

<sup>275</sup> This definition is extracted from the Shāfi'īs' opinion and majority of Muslim jurists. Meanwhile, the Hanafīs' definition is more restricted to naturally desired by man, and can be stored for the time of necessity. It includes moveable and immovable, where they exclude the benefits and something, which is not storable, are non-property, but only as an ownership. For further reference, al-Zuhaylī, *Al-Fiqh al-Islāmī*, vol. 4, 40-42.

perishable, items that will not be destroyed with repeated use, like an article of clothing, a car or a house.

On the other hand, ownership in Sharī'ah is the right to possess, use, sell, donate, or give as a gift any asset. It also means a control or having an authority over something (property/asset/benefit), which impedes someone else from utilizing it and it is allowed (as in line with the Sharī'ah principles) for the owner to dispose or deal it, from the initiation of acquiring the property/asset, except in the matter, which is prohibited by the Sharī'ah.<sup>276</sup> It is not the same as possession, as it is possible to own something without possessing it, or to possess something without owning it.<sup>277</sup> It can be divided into two parts, namely full ownership and partial ownership. The former refers to an acquisition of absolute ownership of a property physically together with its benefit, which can be acquired through contract (*'aqd*), inheritance (*mirāth*) or will (*waṣīyah*). The owner of full ownership can utilize both, the corpus and benefit of the property. Meanwhile, the latter refers to the type of ownership in which the owner has an authority over either the corpus (*'ayn*) or benefit (*manfa'ah*) ownership, but not both. The owner of corporeal ownership (*milk al-'ayn*) has long-lasting proprietorship of the property, but he does not have a right to utilize the property.

In the meantime, for the owner of beneficial ownership (*milk al-manfa'ah*), is a right to utilize the benefits of the property as long as it is permitted by the legal owner or it is in accordance to the terms stipulated in the contract, but not the corporeal property. Beneficial ownership may be acquired through five means, namely; *'i'ārah* (physical/asset loan), *ijārah*, *waṣīyah bi al-manfa'ah* (will to use benefit), *waqf* and permission to use (*al-ibāḥāh*). This can be illustrated in the contract of lease, where the lessee has beneficial right to utilize the benefit of the property, whereas the lessor, as the owner of the physical property, does not have any right to utilize the property, when the property is rented to the lessee. The lessor has a right to terminate the contract if the lessee does not follow the stipulation prescribed in the contract. Meanwhile, the lessee is only allowed to utilize the property in accordance with the stipulation specified in the lease contract, and he could not exchange or sell the property.<sup>278</sup>

The demarcation of the types of property and ownership is very important to Islamic banking, as it will determine which kind of property or asset Islamic banks can

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<sup>276</sup> al-Zuhaylī, *Al-Fiqh al-Islāmī wa Adillatuh*, 57.

<sup>277</sup> Ibid.

<sup>278</sup> Ibid.

deal with. For example, it is argued that option is not regarded as a valid property in Sharī'ah; therefore, it is not valid to be traded. According to Usmani (1999), an option is a promise to sell or purchase a thing on a specific price within a specified period. Such a promise in itself is permissible and is normally binding on the promisor. However this promise cannot be the subject matter of a sale or purchase, since promise is not recognized as a subject for sale. Therefore, the promisor cannot charge the promisee a fee for making such a promise.<sup>279</sup> Similarly, Sharī'ah only recognizes five causes of beneficial ownership, as stated previously; however, there is another concept in common legal system that gives beneficial ownership to the buyer, as practiced in *ṣukūk* transaction. This beneficial ownership only gives a right of cash flow to the owner (*ṣukūk* holder certificate), but not to the asset that is generating the cash.

#### 2.8.4. Risk management

Generally, risk can be defined as the probability that the future outcome and return may differ from the expected return.<sup>280</sup> In order to develop a viable Islamic banking product, the bank is required to consider the risks that are normally faced by the banks. There are many types of risk classified by scholars in managing risks. Risks that directly affect the product development process can be divided into financial, business, operational risks.<sup>281</sup> Financial risks are the exposures that result in a direct financial loss to the assets and liabilities of a bank, and it is usually associated with leverage that obligations and liabilities cannot be met with current assets.<sup>282</sup> It is regarded as the first risk that appears in the discussion and policy of banking management. Among the classified financial risks identified are credit risk, market risk and equity risk. Credit risk is associated with the potential risk that a counter party, i.e. customer will fail to make payments on his obligations in accordance with the agreed terms. For example, in

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<sup>279</sup> Muḥammad Taqī Usmani, "What Sharī'ah Experts Say: Futures, Options and Swaps," *International Journal of Islamic Financial Services* 1, no. 1 (April–June 1999): 36–38

<sup>280</sup> Peter Howel and Keith Bain, *Financial Markets and Institutions* (England: Pearson Education Limited, 2007), 402.

<sup>281</sup> Hennie van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (Washington: the World Bank, 2007), 64; Iqbal and Mirarkhor, *An Introduction of Islamic Finance*, 230; Tariqullah Khan and Habib Ahmed, "Risk Management An Analysis of Issues in Islamic Financial Industry," (Occasional Paper no.5, IRTI, 2001), 28-30;

<sup>282</sup> Iqbal and Mirarkhor, *An Introduction of Islamic Finance*, 229; James T Gleason, *Risk: The New Management Imperative in Finance* (Bloomberg Press, Princeton, New Jersey, 2000), 21; Khan and Ahmed, "Risk Management, 26.

the case of *murābahah*, Islamic banks are exposed to this type of risk when the client fails to pay the amount due in time. Meanwhile, market risk arises in the form of unfavorable price movements such as rate of return, benchmark rates, foreign exchange rate, equity and commodity prices, which has a potential impact on the financial value of assets over the life of the contract.<sup>283</sup> Islamic banks are also exposed to equity investment risks; where there is possibility for the enterprise venture based on the contract of *muḍārabah* and *mushārah* by the banks to not realize the expected return.<sup>284</sup> This is unique to Islamic banks considering that conventional banks do not invest on the basis of equity based assets. Islamic bank also may face to operational risk. It refers to the risk of loss resulting from inadequacy or failure or uncertainty of internal process, as related to people or from external risks, including failure of technology, system and analytical models.<sup>285</sup>

On the other hand, business risks are related to a bank's business environment, including macroeconomics and policy concerns, legal and regulatory factors and overall financial sector's infrastructure such as payment systems and the auditing profession.<sup>286</sup> The associated business risk, which is very important in Islamic banks, is the rate of return risked. According to Iqbal and Mirarkor (2008), it refers to the uncertainty in the returns earned by Islamic banks on their assets. This uncertainty can cause a deviation from expectations that the investment account holders have on liabilities side. The larger the divergence, the bigger the rate of return risked. For example, the expected return of the risk is 5%, but the current market rates rise to 6%, which is higher than what the bank may make on its investments. As a result of this scenario, the depositors may deviate or withdraw their investment from the account; hence, the bank is exposed to another risk, namely displaced commercial risk (DCR).<sup>287</sup> DCR is a risk

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<sup>283</sup> Iqbal and Mirarkhor, *An Introduction of Islamic Finance*, 233.

<sup>284</sup> Angelo M. Vernados, "Resilience and Stability: Socioeconomic Response in Southeast Asia," in *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System*, edited by Angelo M. Vernados (Singapore: World Scientific, 2008), 12.

<sup>285</sup> Hylmun Izhar, "Identifying Operational Risk Exposures In Islamic Banking," *Kyoto Bulletin of Islamic Area Studies* 3, no. 2 (March 2010): 17-53; Djojosedjito, "Mitigating Legal Risk, 110-121; Simon Archer and Abdullah Haron, "Operational Risk Exposures of Islamic Banks," in *Islamic Finance The Regulatory Challenge* edited by Simon Archer, Rifaat Ahmed Abdel Karim (Singapore: John Wiley and Sons, 2007), 121.

<sup>286</sup> Iqbal and Mirarkhor, *An Introduction of Islamic Finance*, 235.

<sup>287</sup> V. Sundararajan, "Risk Measurement and Disclosure in Islamic Finance and the Implications of Profit Sharing Investment Accounts," (paper presented at Sixth International Conference on Islamic Economics, Banking and Finance, Jakarta, November 22-24, 2005).

where Islamic banks are under pressure to pay return to its depositors, a rate of return higher than should be payable under the actual terms of the investment contract.<sup>288</sup>

In order to mitigate the risk, a bank normally may decide to waive their portion of profits to retain their deposits and thus deter the depositors from withdrawing their funds, which probably may adversely affect its own capital that can lead to insolvency risks. Therefore, the AAOIFI and the IFSB have created two principles, namely profit equalization reserve (PER) and internal rate of return (IRR), to solve the problem.<sup>289</sup> Unfortunately, the problem with these principles is that most of the capital invested under *muḍārabah* by the bank is not from their own fund but from the accumulated depositors' money. It is argued that the act to waive the profit seems to violate the original principle of *muḍārabah*. It appears to be profited by the bank, as the profits materialized from the venture do not affect their share. However, if the bank, i.e. *muḍārib*, decides to waive their rights to part or all of the profits in order to satisfy and retain their fund providers and deter them from withdrawing their funds, then it is justified as there is no involvement of the depositor's funds. Nevertheless, if the capital is invested under the *mushārah* contract, probably it can be ruminated as both parties contribute their funds in the venture. The IFSB stipulates that the basis for computing the amounts deducted must be pre-defined in the contract, and fully revealed by the banks in their annual report of the PER and IRR's deduction in order to avoid any irregularity in managing the funds. But to what extent the practice is transparent can still be questionable, as there has been no research organized so far to investigate the transparency of the process.<sup>290</sup>

### 2.8.5. Product features

Different products have different contracts and product features. This can be illustrated in *murābahah* financing product. In this respect, the customer identifies the intended asset to be purchased to the bank, where the bank will buy the asset on behalf of the customer. The bank will assess the risk profile of the customer before promulgat-

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<sup>288</sup> V.Sundararajan, "Issues in Managing Profit Equalization Reserves and Investment Risk Reserves in Islamic Banks," *Journal of Islamic Economics, Banking and Finance* 4 (2008): 1-11.

<sup>289</sup> Islamic Financial Services Board, "IFSB-1 Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS),"<sup>23</sup>, accessed on 8 May 2013, [www.ifsb.org](http://www.ifsb.org)

<sup>290</sup> Ibid.



ing the transaction. The bank takes security money (*hamīsh jiddiyah*), as a guarantee that the customer will purchase the asset. It will be refunded if the customer proceeds to fulfil his promise; otherwise the money will be compensated if the customer violates his promise. The bank then purchases the asset from the owner on cash basis. The bank then sells to the customer and it must disclose the cost and the profit rate that it has taken. The customer has two choices, either to pay in deferred payment or on cash basis. If the deferred payment is chosen, then the bank is required to pay instalments, these are monthly payments of a fixed amount. The asset becomes the collateral to guarantee the monthly payment until all the debt is paid by the customer.

In this regard, the bank will scrutinize the terms of financing, such as the cost and the rate undertaken as a profit. Normally, this type of financing involves short and medium term financing, such as vehicle financing. It also can be used as long term financing for a house or heavy machine, which requires some large sum of money. The bank also will prudently scrutinize the risk profile of its customer and credit background in order to evaluate his credit risk. Furthermore, the bank also prepares guarantee, assignment and charge documents for the purpose of guaranteeing the debt of the customer.

## **2.9. Approaches in Developing Islamic Banking Products**

There are many approaches suggested to develop products in Islamic banking. However, the present study only discusses some of the approaches that have been introduced in the market, such as follows:

### **2.9.1. Replication**

The easiest way for developing an Islamic banking product is by replicating the conventional product that has been established in the market. It is a simple way to duplicate the conventional product, as its structures and features can be retained except the underlying principle that must be differentiated. This approach also can be known as *hiyal*-based products, where the Islamic banks modify the prohibited products of conventional banks to become acceptable and compliant to Islamic principles. If the conventional product is interest-based as a principle, then the Islamic product must ap-

ply another principle that is permissible and Sharī‘ah compliant while at the same time, it retains the classical features. For example, in conventional banks, the relationship between the bank and the customer is lending and borrowing. As the former products are prohibited as they are interest-inherited products, therefore, the Islamic banks change the underlying contract of loan contract to sales-based contract and the name of loan facility would be substituted with Islamic financing facility. Here, the bank acts as a seller and the customer as a buyer and the payment of the asset purchased can be made by a deferred arrangement. This product fulfils the Sharī‘ah requirement.<sup>291</sup>

The advantage of this approach is that the customer may easily identify and recognize the product and the bank does not need to spend an extra effort on marketing and advertising, as it is well known in the market.<sup>292</sup> However, the disadvantage of the approach is that the product may not signify itself as having distinctiveness of the Islamic character. It is argued that Islamic banking products should be distinguished from conventional product, as the former cannot usurp interest, which is strictly prohibited. Thus, this concept may not be considered as a new approach in developing new products in Islamic banking, because change is only made in the form but not the substance.<sup>293</sup> Since it is based on replication, conventional industry will always be the leader resulting Islamic banking products are the follower of the design of the conventional industry. As a result, the product will always be an inferior product to its conventional counterpart since the product implies the same objectives for conventional ones, but with only the additional prohibitions of Sharī‘ah rulings. By the replicating conventional product, the Islamic banking products will also face the same problems as conventional ones since conventional products are developed to solve conventional problems.<sup>294</sup>

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<sup>291</sup> Aishath Muneeza, Nik Nurul Atiqah Nik Yusof, Norariefah Mohd Iqbal and Juyda Noor Mohamad, “Hilah in the Islamic Banking Instruments in Malaysia,” *Malayan Law Journal* 1 (2011): 1iv-1xv

<sup>292</sup> Another good example of this approach is the Islamic house financing facility, which uses two contracts of *murābaḥah* (cost mark-up sale) - also known as *bay‘ al-ṭinah* (double sale transactions). This subject will be discussed in chapter 4, page 186 under the subtopic of *hiyal* in practice. For further reference, see Saiful Azhar Rosly, “Al-Bay‘ Bithaman Ājil financing Impacts on Islamic banking Performance,” *Thunderbird International Business Review* 41, no. 4-5 (July-October 1999): 461-480; Edib Smolo, “Al-Bay‘ Bithamān Ājil (BBA) as Practiced in Malaysia a Critical Review,” *Journal of Islamic Banking and Finance* (January- March 2010): 60-75; Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets, Islamic Economics, Banking and Finance, Investments, Takāful and Financial Planning* (Kuala Lumpur: Dinamas, 2005), 88-89, 91.

<sup>293</sup> Iqbal, “Financial Engineering in Islamic Finance,” 541-560.

<sup>294</sup> Sami al-Suwailem and M. Kabir Hassan, “An Islamic Perspective on Financial Engineering,” 385-400.

According to El-Gamal (2006), Islamic banking products will lose their economic efficiency due to the adoption of replication as a model for product development. He argues that the process of replication is undertaken through reengineering the classical contracts in order to construct the product similarly to conventional ones. As interest is prohibited, the alternative is by employing the sales contracts as the substitution. As such, the Islamic bank needs to bear additional costs that can be avoided such as sales tax due to multiple sale transactions embedded in the structure of the contract. In the conventional legal framework, each sale is subjected to sales tax but not interest. This unfriendly environment has made the products less attractive and expensive especially in the western countries that do not support the growth of the Islamic banking industry.<sup>295</sup>

### 2.9.2. Product augmentation

Product augmentation or enhancement is extra element added in the existing product that aims to strengthen the structure of the product. The purpose of this approach is to make the product more attractive and financially viable in the market.<sup>296</sup> It is also employed to secure a transaction between the contracting parties. Theoretically, such additional elements would not change the existing concept of the product but simply add therein more features into the product.

A good example is the issue of third party guarantee in *muḍārabah* contract. The original rule of *muḍārabah* contract is that the entrepreneur is not allowed to guarantee the fund provided by the capital provider and its profit. The fact that the capital provider is supposed to bear all the losses makes it unpopular from the customer's perspective. Nevertheless, the SACBNM allowed third party guarantee as long as the guarantor has no direct interest involved in the investment, the entrepreneur, and the capital provider. Strictly speaking, third party guarantee is considered as a volunteer party gratuitously wishes to insure the investment in terms of its principal loss and not the profit gained. The SACBNM justifies such approach as consistent with the permissibility of *kafālah* contract that can be applied to the investment as long as the entre-

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<sup>295</sup> El-Gamal, *Islamic Finance*, xi-xii.

<sup>296</sup> Bakar, "Sharī'ah Approaches," 126.

preneur and capital provider have no any direct relationship with the third party.<sup>297</sup> Third party guarantee would not change the original status of the *muḍārabah* contract. Usually, among the third parties involved in this guarantee scheme are *takāful* companies and government-linked firms. This is objectively aimed to attract the investors who are risk averse in order for them to invest in the investment project based on *muḍārabah* contract.

Other example is the use of *wa'd* in *murābaḥah lil-āmr bi al-shira'* (*murābaḥah* purchase-ordered sale), where a buyer approaches, normally an Islamic bank to finance the purchase of his asset. This financing is organized systematically where the bank first purchases the asset and then subsequently sells it to the customer under *murābaḥah* contract. However, in the original rules of *murābaḥah*, the buyer is not tied to purchase it from the bank after the initial purchase is made, thus this situation gives rise to some risks (e.g. credit and market risk) faced by the bank if the customer refuses to purchase it. In order to secure the transaction, the bank orders the buyer to provide a unilateral purchase undertaking (*wa'd bi shirā'*) in the promissory agreement that he will purchase the asset after the purchase is made by the bank.<sup>298</sup> Furthermore, to secure the promissory agreement, *hamīsh jidīyyah* (security deposit) is imposed on the buyer.<sup>299</sup> It is the amount paid by the buyer to the bank in order to ensure that the buyer is serious in his order of the asset. The promise is binding and if the buyer refuses to purchase the asset, the actual loss incurred by the bank shall be made good for this amount.<sup>300</sup>

Besides, *bay' al-'urbūn* (earnest money) is another concept used in Islamic banking products, especially in *murābaḥah* types of product. It is the amount paid by the client (buyer) to the seller (bank) when the former purchases an asset from the seller. If the customer proceeds with the sale and buys the asset over, then the down payment will be part of the price; otherwise, the payment will be for the seller. Both concepts have been employed rigorously in modern Islamic banking and are brought into new perspective to suit the modern banking environment. This is because the tradition-

<sup>297</sup> Bank Negara Malaysia, *Sharī'ah Resolution*, 35-36.

<sup>298</sup> Ray, *Arab Islamic Banking*, 46.

<sup>299</sup> Bank Negara Malaysia, *Sharī'ah Resolution*, 145-146; AAOIFI, *Al-Ma'āyir al-Shar'īyah*, Standard no. 8 (*Al-Murābaḥah li al-Amr bi al-Shirā'*), paragraph 2/5/3 (Bahrain: AAOIFI, 2008), 103; Mohammed Obaidullah, "Financial Engineering with Islamic Options," *Islamic Economic Studies* 6, no. 1 (Nov.1998):73-103.

<sup>300</sup> Shahul Hameed Mohamed Ibrahim, *Accounting and Auditing for Islamic Financial Institutions* (Kuala Lumpur: IIUM Publisher, 2008), 200.

al contracts (*murābahah*, *mushārahah*) are not feasible and cannot be applied directly in the contemporary banking business. In other words, these contracts need some adjustment to qualify as mechanisms to be used as financially viable instruments in banking product.<sup>301</sup>

It has been stressed previously that these instruments would not change the nature of the existing contract. However, its implementation shows otherwise, where it has attracted some criticisms by some scholars. The Ḥanafīs and Shāfi'īs only concern on the form and appearance of the contract and they argue that as long as the contract fulfils all the requirements; the pillars and conditions of the contract, it can be considered as a valid contract.<sup>302</sup> On the other hand, the Mālikīs and Ḥanbalīs argue that the arrangement defeats the original purpose of the concept. For example, the issue of third party guarantee for *muḍārahah* is regarded as a *ḥilah* that attempts to circumvent *ribā*. In principle, *muḍārahah* capital is not supposed to be guaranteed and is required to be exposed to risks that are (e.g. market and business risks) associated with the investment. When the capital is guaranteed, it seems that the entrepreneur does not get the capital for investment but a loan, since a loan is guaranteed its principal. Thus, they argue that the contract should be named as a loan and all requirements of the contract must be observed instead of it being called *muḍārahah*.<sup>303</sup> Furthermore, this perspective has argued that it is unimaginable in a practical manner of the modern period for an independent entity to provide a benevolent party as a guarantor for the potential loss of another party without any specific considerations, be it a monetary consideration or services.<sup>304</sup> Since there is no party to offer a voluntary guarantee, there is an argument to allow a fee to be charged as the guarantee. Nonetheless, this also causes Sharī'ah problems, if some fee is charged, then the party could be considered as the independent third party and has contradicted the principle of voluntary, since it does not charge any monetary compensation. The contract could not be called anymore as a voluntary contract but as *ijārah* or *kafālah bi al-ujr* (guarantee with fee), which is equivalent to commutative contract. When it is similar to commutative contract, then the transaction is regarded as the exchange of money with money, which is similar to prohibited *ribā*

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<sup>301</sup> Ibid.

<sup>302</sup> Muḥammad ibn Ismā'īl al-Ṣan'ānī, *Subul al-Salām al-Muṣīlah ilā Bulūgh al-Marām* (Makkah: Dār Ibn Jawziyyah, 1421H), vol. 5, 37-38.

<sup>303</sup> El-Sharif, "Law and Practice of Profit-Sharing, 73.

<sup>304</sup> Muḥammad Al-Bashir Muḥammad Al-Amine, "Ṣukūk Market: Innovations and Challenges," *Islamic Economic Studies* 15, no. 2 (Jan. 2008):1-22.

*al-faḍl*. In Malaysia, the SACBNM recognizes however third party guarantee as permissible to the extent of guaranteeing the capital only and not the profit gained.<sup>305</sup>

### 2.9.3. Product mutation

As opposed to product augmentation, product mutation or modification is a process that starts with some acceptable Islamic contracts and then adjustments, revisions, variations, and adaptations are made in order to suit the contracts to the modern requirements of the banking business. According to al-Suwailem and Hasan (2011), this approach could generate an effectively infinite number of products. Given the fact that the products at the beginning of the process are all Sharī'ah-compliant, a substantial modification of the contract would also be acceptable.<sup>306</sup> By putting a new dimension and perspective to the classical contract, the feasibility of the contract to be offered in Islamic banking will be enhanced.

The best illustration of a classical contract that has gone through the process of modification is *istiṣnā'*. The contract historically evolved due to the specific needs in the areas of manual work such as carpentry, shoemaking, or leather production. However, this contract gradually grew in modern time and became an important financial tool to meet the need of financing major developments in infrastructure and industrial projects such as the building of ships, airplanes, large machinery and others. *Istiṣnā'* is a contract of production and manufacturing, in which a manufacturer is responsible for both material and labor in order to deliver a specified item to the customer in future. This is similar to the contract of *salam* whereby the manufactured item is delivered in the future. In contrast to the payment of the price in *salam* which must be paid in advance, the *istiṣnā'* contract permits the payment can be made either in advance or after the product is completed. This is also similar to *ijārah* (leasing) contract as the provider of *ijārah* is responsible for the labor albeit not the material, whereby in *istiṣnā'*, the manufacturer is responsible to provide both elements. The modification and mutation

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<sup>305</sup> Bank Negara Malaysia, *Sharī'ah Resolution*, 173.

<sup>306</sup> Sami al-Suwailem and M. Kabir Hassan, "An Islamic Perspective on Financial Engineering," 385-400.

process have resulted in the emergence of a new contract, i.e., *istiṣnā'*, which has different characteristics from both contracts.<sup>307</sup>

#### 2.9.4. Combination of contracts

There are many nomenclatures that can represent this approach either, contractual amalgamation, combination of contracts, or consolidation of multiple contracts. This approach has been frequently employed in developing new Islamic banking products where one contract is combined with another contract in a single arrangement to achieve specific objectives as desired by the contracting parties and does not partake in any separation and division.<sup>308</sup> Typically, the combination of contracts may include any contracts; either commutative contracts (*uqūd al-mu'awadah*), such as sales and lease contracts or non-commutative contracts, such as *hibah* and *waqf*, or supporting contracts, such as mortgage, guarantee and debt transfer to be combined into a single arrangement. These contracts must be concluded in a separate transaction, since each contract has its legal consequences and principles. If each contract combined neglects this principle, the combination would be declared as void combination from the Shari'ah perspective. Nonetheless, there is an argument by scholars such as Hammad (2005) and al-Umrani (2006) that the combination may not partake to any separation, since it will inhibit the desired objectives of the contracting parties to be achieved.<sup>309</sup> Whenever the combination is taken from the nominated contracts, the structure of the combination must honor each legal consequence (*muqtaḍā al-'aqd*) attached to these contracts. This is to avoid any conflict with the Shari'ah precepts of the contracts combination.

The AAOIFI in this respect issued specific parameters in order to regulate the use of combination of contracts in Islamic financial services and to avoid the mechanism to be used as a legal stratagem. The first parameter is that the process of combination must not contradict the explicit sources of the Qur'ān and the Sunnah. If there is an explicit source that prohibits certain contracts from being combined for any reason, the

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<sup>307</sup> Al-Zuhaylī, *Financial Transactions in Islamic Jurisprudence*, 268-271.

<sup>308</sup> Nazih Ḥammād, *al-'Uqūd al-Murakkabah fī al-Fiqh al-Islāmī: Dirāsah Ta'siliyyah li al-Manzumāt al-'Aqdīyah al-Muthadathah* (Dimashq: Dār al-Qalam, 2005), 6.

<sup>309</sup> Ḥammād, *al-'Uqūd al-Murakkabah fī al-fiqh al-Islāmī*, 13; Abd Allāh Muḥammad al-'Umrānī, *al-'Uqūd al-Māliyyah al-Murakkabah: Dirāsah Fiqhiyyah Ta'šiliyyah wa Taṭbiqīyyah* (Riyāḍ: Kunūz Shibliyyā', 2006).

product becomes unacceptable in Sharī‘ah. Second, the combination of contracts is not intended to circumvent impermissible transactions such as *bay‘ al-‘īnah*. Third, the combination of contracts should not be a means for dealing with *ribā* transactions. Fourth, the contracts combined must not contradict with each other in terms of their legal consequences. For example, a sale (pecuniary contract) cannot be combined with loan (non-pecuniary type of contract).<sup>310</sup>

A good example of practice in this case is *mushārah mutanāqishah*, which consists of three nominated contracts (*‘uqūd al-musammā*) combined; *mushārah*, *ijārah* and *bay‘* contracts with a unilateral undertaking of promise (*wa‘d*).<sup>311</sup> The performance of the contract is firstly started with the agreement of the bank and the customer to purchase an asset (e.g. a house) as jointly owned (*mushārah*) through the sharing of 80:20 portions of the shares respectively. Afterwards, the bank agrees to rent its shares (80%) to the customer. In order to dispose its shares, the bank allows the customer to purchase the asset gradually until its shares reach to zero (0%). To secure that the customer will make the purchase, a unilateral purchase undertaking is applied by the bank in order to guarantee that the customer will buy the shares until they are completed. It will become a good tool for product development as Sharī‘ah gives some flexibility to combine contracts to achieve the desired objectives of the contracting parties. Combination of contracts is valid if it passes the test established by the Sharī‘ah authorities, such as the AAOIFI, and then there is no legal objection for the bank to develop any product based on the mechanism.<sup>312</sup>

### 2.9.5. New contract and product

Another approach of product development is creating a new contract or developing a product different from the nominated contracts (*‘uqūd musamma*) in the classical Islamic commercial law. Besides, this product may also differ from the existing products or in the market. For the first approach, a new contract that will be developed must meet specific requirement be it for the customer, regulatory board, or the industry. The creation of a new contract is permitted in Sharī‘ah as long as it is not contrary to

<sup>310</sup> AAOIFI, *Al-Ma‘āyir al-Shar‘īyah*, 458-459.

<sup>311</sup> ‘Abd al-Sattār Abū Ghuddah, “Mushārah Mutanāqishah and Its Sharī‘ah Parameters,” accessed 23 November 2013, <http://www.ifkr.isra.my>.

<sup>312</sup> Arbouna, “The Combination of Contracts in Sharī‘ah,” 341–369.



the explicit sources of the Sharī‘ah. For example, it is argued that option contract is some kind of a new contract in an Islamic commercial transaction.<sup>313</sup> An option is a contract between two parties, one party (the buyer) has the right, but not the obligation, to buy or sell a specified asset at a specified price, at or before a specified date, from the other party (the seller). The seller of the option has a contingent liability or an obligation to be activated if the buyer exercises that right.”<sup>314</sup> The characteristics of the contract are not similar to any nominated contracts in the classical *fiqh* discussion. As the methodology of Islamic commercial law is to subsume any new contract under the scheme of nominated contract, some scholars (e.g. Kamali and al-Amine) attempt to incorporate it under *bay‘ al-‘urbūn* contract and the option of stipulation (*khiyār al-sharṭ*).<sup>315</sup>

Securitization is a contract, which cannot be deemed as similar to nominated contract. It was originated in the US in the 1970s and within a few decades, it gained acceptance as a very important financial product within the conventional banking sector.<sup>316</sup> It is a process of issuing securities by selling financial assets identified, as the underlying asset to a third party. The purpose of securitization is to liquidate financial assets for cash or as an instrument to obtain new funds at a more attractive cost, compared to obtaining funds through direct borrowing from financial institutions.<sup>317</sup> It is also a process that an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promote liquidity in the marketplace.<sup>318</sup> It has been employed in the industry particularly in recent innovations of *ṣukūk* (investment certificate) issuance based on various Islamic contracts such as *ijārah*, *mushārah*, *bay‘*, *salam* and others.<sup>319</sup>

<sup>313</sup> Vogel and Hayes, *Islamic Law and Finance*, 164.

<sup>314</sup> al-Amine, *Risk Management in Islamic Finance*, 196.

<sup>315</sup> Kamali, *Islamic Commercial Law*, 181-205.

<sup>316</sup> Faizal Ahmad Manjoo, “Securitization: An Important Recipe for Islamic Banks: A Survey,” *Review of Islamic Economics* 9, no. 1 (2005):53-74.

<sup>317</sup> Securities Commission of Malaysia, *Resolutions of the Securities Commission Sharī‘ah Advisory Council* (Kuala Lumpur: Securities Commission, 2007), 67.

<sup>318</sup> Investopedia, “Securitization,” accessed on 10 June 2012, <http://www.investopedia.com/terms/s/securitization.asp#ixzz1xM4jxRHm>

<sup>319</sup> Muḥammad Ayub, “Securitization, Sukuk and Fund Management Potential to be Realized by Islamic Financial Institutions,” (paper presented at International Conferences on Islamic Economics and Finance, Jakarta, 2005); Yasemin Zöngür, “Comparison between Islamic and Conventional Securitization: A Survey,” *Review of Islamic Economics* 13, no. 2 (2010):81-118.

### 2.9.6. Customer preference

Another approach is to structure a product according to customer preferences, needs, and satisfaction. In order to understand customer preferences and needs, one would require a great deal of research for the financial institutions to explore the potential customers and their needs. The results of such research would bring a great opportunity for financial institutions to organize their product development policy. For instance, a customer needs a financing facility that can facilitate his purchase of a house. The Islamic bank acts the financier or facilitator by purchasing the property intended by the customer first, then the customer is required to purchase back the property from the bank. Instead of paying the price of the property in cash, which burdens the customer, the bank allows him to pay the price through deferred payments. Besides, this type of financing, there are other various mechanisms used in contemporary Islamic banks to provide such facilities, for instance, *ijārah* or *ijārah mawsūfah al-dhimmah* (forward lease) or *mushārah mutanāqishah*. Through these means, the Islamic bank would satisfy the requirement of the customer who needs a house through Islamic financing. Both parties enjoy the benefits - the bank gains profit and the client owns the house, and both parties achieve their desired objectives.

### 2.9.7. Market segmentation

Besides, market segmentation is another approach to develop a new product, as asserted by Ansoff (1957). Its objective is to design a marketing mix that precisely matches the expectations of customers in the market.<sup>320</sup> The first matrix is that Islamic bank can focus on offering the existing products to the existing customers. The goals of this approach are to retain customers and resolve product saturation. Innovation can still occur through the service quality offered and the repackaging of existing product, to appeal to the existing customer. Secondly, Islamic bank can offer a new product to a new customer. The bank needs to develop new products that customers wish for through a process of consumer research and creating effective marketing strategies. The objective of this approach is similar to the above, which is to retain the existing cus-

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<sup>320</sup> Business Dictionary, "Market segmentation," accessed on 12 July 2012, <http://www.businessdictionary.com/definition/market-segmentation.html#ixzz20Q4KcHB6>

tomers. Thirdly, Islamic bank can offer existing product to new Muslim and non-Muslim customers. Tackling new Muslim customer can be done by convincing them of the primacy of the religious values; the product is Sharī'ah compliant. Non-Muslims who might not be interested in the Muslim conviction of *ribā*, *gharar* and *maysir* in the transaction can be persuaded by the ethical and moral aspects of the product. Finally, Islamic bank may develop a product based on the market expansion where a new product can be offered to a new market. This can be done through geographic diversification where there is no Islamic bank established especially in the western countries. This potential for market penetration is not only to cater to the needs of Muslim but also the whole population of non-Muslim.<sup>321</sup>

## 2.10. Product Approval

The process of Sharī'ah approval refers to the procedure prior to the commercialization of the product. It must be validated and approved by the Sharī'ah board of the Islamic bank. In this respect, the BNM provided a guideline to ensure the transparency and accountability of the Sharī'ah decision-making made by both bodies. This process is regulated by the Sharī'ah governance framework. It is a framework that consists of BoD, Sharī'ah committee, management, Sharī'ah review, Sharī'ah audit, risk management, Sharī'ah department and Sharī'ah decision that will observe the process of Sharī'ah-decision making is made. BoD is the highest body to oversee all aspects of the operations of an Islamic bank including Sharī'ah compliance. Every department and organization in the Islamic bank must report to the BoD. Meanwhile, Sharī'ah committee, with the composition of qualified personnel is the responsible party to deliberate Sharī'ah issues engaged and provide sound Sharī'ah decisions (*fatāwā*). On the other hand, the management of the bank is accountable to provide sufficient resources, information, and manpower to support the Sharī'ah governance framework in order to ensure its business operations are compliant with the Sharī'ah precepts. Sharī'ah review deals with conducting reviews on a continuous basis on the processes, and deliverables of operations of Islamic bank in accordance to the Sharī'ah. Meanwhile, Sharī'ah audit is exercised on an annual basis to validate the functions and operations of the bank with

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<sup>321</sup> Joseph DiVanna and Antoine Sreih, *A New Financial Dawn: The Rise of Islamic Finance* (UK: MPG Book Group, 2009), 75-80.

Sharī'ah. Sharī'ah-compliant risk management is the process to identify all possible risks of Sharī'ah non-compliance and the remedial measures that need to be taken to reduce the risks. Finally, an internal Sharī'ah team that is responsible to conduct research on the Sharī'ah issues in order to produce Sharī'ah decisions. Once, the Sharī'ah decision is obtained, Islamic bank is also responsible to disseminate the Sharī'ah decision to internal and external shareholders.<sup>322</sup>

The processes of Sharī'ah approval involve searching for suitable contracts that accommodate the product from the Sharī'ah perspective and justifying the structure of the product with various methodologies of Sharī'ah. Once the committee of product development approves the product, then it will be presented to the Sharī'ah committee. The Sharī'ah committee is responsible to endorse and validate, especially the legal documentation of the product. The committee will observe the terms and conditions contained in the proposal form, contract, agreement or other legal documentation in executing the transactions. Besides, the committee also will endorse the product manual, marketing advertisement, sales illustrations and brochures employed to describe the product.<sup>323</sup> Specifically, the process of Sharī'ah approval can be described in the following stages<sup>324</sup>:

### **2.10.1. Product design and development**

At this stage, product is designed by the business unit of the Islamic bank, such as consumer, finance, risk management, treasury, corporate business or wealth management department. On the other hand, some of the Islamic banks also form a special committee of product development that constitutes of various departments within the bank (e.g. IT, Finance, Sharī'ah department), where the design, conceptualization and development are discussed among the members of the committee. In this case, the con-

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<sup>322</sup> Bank Negara Malaysia, "Sharī'ah Governance Framework for Islamic Financial Institutions," accessed on 10 August 2013, [http://www.bnm.gov.my/index.php?ch=en\\_reference&pg=en\\_reference\\_index&ac=584&lang=en](http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en).

<sup>323</sup> Bank Negara Malaysia, "Guideline on the Governance of Sharī'ah Committee," accessed on 10 August 2013, [http://www.bnm.gov.my/index.php?ch=en\\_reference&pg=en\\_reference\\_index&ac=584&lang=en](http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en).

<sup>324</sup> These processes are heavily drawn from the discussion made in December 2010. Among the officers involved are CEO, Sharī'ah officers, risk managers, and product development officers, as well as officers from Islamic Banking and Takāful department, Bank Negara Malaysia. The Islamic banks participated in the discussion were Maybank Islamic Berhad, Bank Islam Malaysia Berhad and Kuwait Finance House (M) Berhad.

tribution from Sharī'ah department is important to guide and explain the position of Sharī'ah legal rulings with regard to the product to be developed so that it is not deviate from the Sharī'ah principles. Sharī'ah department also is required to study extensively all aspects of the product, the structure, and the Sharī'ah justifications to be provided on the product. Specifically, the responsibility of the department is to ensure that the product is Sharī'ah compliant before it is presented at the Sharī'ah committee. The department is required to evaluate and examine the structure of the product, to identify any possible prohibited elements in the product, to seek feedback and advice and to amend or to find alternative solution for the product after it was presented at the Sharī'ah committee. Furthermore, the paper of the product that will be presented at the Sharī'ah committee must include the following details; the name of the product and objectives of the paper submission, whether the submission is for obtaining the approval of the Sharī'ah committee or getting advice or only for notification and information. The paper also must provide the background, concept, flow, types of contracts engaged, the contracting parties, the rights and obligations of the relevant parties, the issues to be deliberated at the Sharī'ah committee and finally the recommendation of the product owner on the submitted proposal.<sup>325</sup>

#### **2.10.2. Submission to the Sharī'ah Committee of the bank**

Once all relevant parties engaged in the product development committee agree on the product concept, structure and design, then the product is presented at the Sharī'ah committee meeting. Sharī'ah department is required to ensure that the meeting is attended by all the Sharī'ah members appointed. At that meeting, the product will be presented about its concept, feature, structure, Sharī'ah underlying contract used as well as some Sharī'ah potential issues confronted by the product. The presentation will provide a comprehensive background and the Sharī'ah committee will actively participate on the presentation to ensure that they fully understand the whole structure of the product, prior to making any decision. After deliberation and discussion, the Sharī'ah board takes its decision in the form of a resolution (*fatwā*). The decision may be that the board approves the product and it can be launched, or if there are some flaws in

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<sup>325</sup> BNM, "Guidelines on Introduction of New Products," accessed on 11 August 2013, [http://www.bnm.gov.my/index.php?ch=en\\_reference&pg=en\\_reference\\_index&ac=584&lang=en](http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en)

terms of Sharī'ah characteristics, some modifications are required to be done so that it complies with the Sharī'ah precepts or the board may reject the product, if it does not fulfil the Sharī'ah requirement or is contrary to the Sharī'ah precepts.<sup>326</sup>

### **2.10.3. Submission to the BNM**

Once the product obtains the approval from the Sharī'ah committee then, it will be submitted to the secretariat of the SACBNM. This is the final step; where the product is presented at the SACBNM's meeting and the same processes are rigorously repeated where at the final stage of the SACBNM may approve, modify or reject the product. In cases where the product needs some modifications, the product goes back to the bank. The bank is required to make the adjustments based on the recommendation of the SACBNM so that it complies with the requirement of the Sharī'ah.<sup>327</sup>

### **2.10.4. Promotion and commercialization**

After the product is approved by the SACBNM, and then finally, the Islamic bank may prepare to launch, promote and commercialize the product. Meanwhile, the decision of the Sharī'ah board will be recorded and documented, and the endorsement of the product will be confirmed at the following meeting by the Sharī'ah board, and the case will be closed accordingly.<sup>328</sup>

## **2.11. Conclusion**

The above discussions have presented the basis of product development for Islamic banking practiced in Malaysia. It can be concluded that there is not much difference with regard to approaches undertaken by the Islamic banks in developing their products. The main concern is for Islamic banks to observe the moral and ethical dimensions as stated in the Sharī'ah framework. Thus, much attention is paid to the pro-

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<sup>326</sup> Ibid.

<sup>327</sup> Ibid.

<sup>328</sup> Ibid.

cess of Sharī'ah approval. In order to regulate Sharī'ah decision-making, a specific Sharī'ah framework has been established by the regulator. This framework will be discussed next.

## CHAPTER 3: LEGAL AND REGULATORY ISSUES IN DEVELOPING ISLAMIC BANKING PRODUCTS

### 3.1. Introduction

*“Prudential supervision is just as necessary in an Islamic banking framework as in conventional banking to reduce risks to the soundness of the banking system and enhance banks’ role as active players in the development of the economy” (Errico and Farahbaksh, 1999)<sup>329</sup>*

The Malaysian Islamic banking industry is highly regulated by a set of legal and regulatory framework established by the government (i.e. the Minister of Finance and Bank Negara Malaysia). The government through its central agency, namely Bank Negara Malaysia monitors the activities and operations of IBIs including the process of product development to ensure the product comply with the national legal system and the Sharī‘ah requirements. The benefit of having a sound legal and regulatory framework is it will protect the rights and obligations of the contracting parties as well as offer public confidence to the industry. On the contrary, the uncertainty and vagueness of the legal and regulatory system that regulates the operations and products of Islamic banking will create a legal conundrum for the development and advancement of the industry.<sup>330</sup> Since, the Islamic banking industry is considered as a new industry, it faces various challenges in terms of legal and regulatory infrastructure.

This chapter aims to discuss the legal and regulatory issues and challenges in regulating and monitoring product development in the Malaysian Islamic banking industry. The first challenge starts with an introduction of Sharī‘ah and common law and its differences. Thereafter, the chapter will discuss a specific law governs the operations of Islamic banking, namely the Islamic Financial Services Act 2013 and its cri-

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<sup>329</sup> Luca Errico and Mitra Farahbaksh, “Islamic Banking Issues in Prudential Regulations and Supervision” (Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999, 195-214)

<sup>330</sup> The legal framework in this study refers to laws or set of rules or procedural steps that provide Islamic banking with the legitimate expediency, economic efficiency, and the basic requirements for establishing sound financial institutions and markets. On the other hand, regulatory framework refers to a system of regulations employed to enforce the laws legislated, which are usually enforced by the government to regulate the Islamic banking industry. For further discussion on the polemics of the Malaysian legal system with Islamic financial services see Muḥammad bin Ibrahim, “The Polemics of Governing Law in Islamic Finance: Recent Developments and the Way Forward,” (keynote address at the International Sharī‘ah Research Academy for Islamic Finance, Institute of Islamic Banking and Insurance (ISRA-IIBI) 2nd Annual International Thematic Workshop 2010: “The Polemics of Governing Law in Islamic Finance,” London, 29 November 2010)



tiques. This will be followed by a discussion on the role of the Sharī'ah advisory council and the Sharī'ah governance system. This is followed with an explanation of legal jurisdiction's issues in the Malaysian legal system. Furthermore, this chapter will discuss Sharī'ah-compliant risk challenge in the process of product development. Finally, this chapter is ended with a discussion on legal documentation of Islamic banking products in order to mitigate Sharī'ah-compliant risk.

### 3.2. Sharī'ah and Common Law

Islamic banking products and services provided by Islamic banks in Malaysia currently have been internationally recognized similar to the standard of products and services provided by conventional banking system.<sup>331</sup> In terms of the legal framework, however, Islamic banking in Malaysia is still dependent on the conventional legal framework, where there are two sets of legal framework are working and regulating Islamic banking operations, namely common law and Sharī'ah. Both legal systems are different particularly on the sources and principles. The sources of common legal system are derived from customary practices, judiciary law, case law, statutes, and set of legal rules. In contrast, Sharī'ah is generally based on the Qur'ānic verses and the Prophetic traditions. These legal rules are then specified by Sharī'ah scholars in the books and treatises as well as compressed in the form of legal maxims, *al-qawā'id al-fiqhiyyah*. To be relevant in the modern times, both legal systems are expanded through different mechanisms. The common legal system is expanded through precedent cases, whereas for Sharī'ah, the mechanisms used to expand are analogical reasoning, consensus, and juristic preference.

In this respect, Islamic banking has different grounds and principles from conventional banking. This can be illustrated in the conventional banking system, where its profit is mostly generated from lending business and rate of interest is considered as the backbone of the system. On the other hand, the profit of Islamic banking system must be realized through the risk undertaken by the bank as it is prohibited to usurp *ribā*.

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<sup>331</sup> Mohamed Hisham Yahya, Junaina Muḥammad, Abdul Razak Abdul Hadi, "A Comparative Study on The Level of Efficiency between Islamic and Conventional Banking Systems in Malaysia," *International Journal of Islamic and Middle Eastern Finance and Management* 5, no. 1 (2012): 48 – 62; Saiful Azhar Rosly; Mohd Afandi Abū Bakar, "Performance of Islamic and mainstream banks in Malaysia," *International Journal of Social Economics* 30, no. 12 (2003): 1249-1265.

Thus, Islamic banking requires a different set of legal system, one that would reflect the Sharī'ah principles to every operation performed by the bank. Therefore, it does not properly work, if the same measures taken to resolve Islamic banking problems<sup>332</sup>

The continuing application of common legal system can be noticed since the period of British colonization and even after the country was independent in 1957, the country still adopts the British legal system. During the colonial period, Sharī'ah law is only applied in limited spaces especially in the matter of personal status (*munākaḥāt*).<sup>333</sup> The narrowing scopes of Sharī'ah law caused inefficiency of the law to regulate the social-economic practices of the country, especially to the new matters, such as Islamic banking and finance.

Although two legal set of laws have differed to each other, to some extent both laws share some similarities. The basic presumption of the common law system maintains that it is unfair to treat similar cases differently, even though they happened in different contexts. In common law system, the precedent case is regarded as the sources of law for judges to establish the decision and the legal ruling for the new case tried in the court. The court will find the common facts inherited by the legal decision made for previous cases and decide upon the new case being heard. If it is found that the new case inherits similar facts, then the court is bound to follow the legal reasoning made by past court's judgment. This is normally known as the principle of *stare decisis* (the authority of legal precedent). Nonetheless, if the court finds that the current case is essentially dissimilar from all the previous cases (called as matter of first impression), then the court has a power and an obligation to create a new precedent through which it will bind future cases.<sup>334</sup>

On the other hand, Sharī'ah law seems similar to common law in terms of the methodology used to derive the law. Sharī'ah jurists or judges in the Sharī'ah courts will normally refer to the sources of Sharī'ah, however, as the sources of Sharī'ah only provide general directives and not specific codes that would address the problems en-

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<sup>332</sup> A. Muneeza, A. Wisham, R. Hassan, "The Paradox Struggle between the Islamic and Conventional Banking Systems," *Journal of Asia Pacific Studies* 1, no. 2 (2010): 188-224.

<sup>333</sup> Although common law practiced in Malaysia can be argued as "secular law," which demarcate between profane and religious affairs, however, as asserted by Tun Abdul Hamid Mohamad, Retired Chief Justice of Malaysia, the law still can be considered as "Islamic" provided that the law does not contravene with the general principles of Sharī'ah. See Abdul Hamid Mohamad, "Harmonization of Common Law and Sharī'ah in Malaysia: A Practical Approach," (paper presented at Abd Al-Razzaq Al-Sanhuri Lecture Islamic Legal Studies Program Harvard Law School, 6 November 2008).

<sup>334</sup> William Tetley, "Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified)," *Louisiana Law Review* 60(2000): 677-738.

countered. Most jurists will search for legal precedents established in the classical books or judgments that had been decided by previous jurists or judges. This is similar to the common law system, where the judges are required to refer to national laws or statutes and the precedent cases, as the source of law, before deciding upon any cases.<sup>335</sup> If the Sharī'ah judges find that the new case is similar to the old case particularly that both cases are based on equal sharing of the underlying effective cause (*'illah*), and then they would apply directly the previous legal decision to the new case. This methodology is known as analogical reasoning (*qiyās*). This also happens in the common law system, where if the new cases presented contain very similar facts to those of the previous cases, then the court will just follow and apply the same law to the new cases.

However, when the facts are materially different, both laws will exercise their own discretion. Sharī'ah judges will attempt to derive a just ruling based on various principles delineated in Islamic legal theory (*uṣūl al-fiqh*), whereas in common legal system, the judge will use his rational, law of equity and rule of law established in the common legal system.<sup>336</sup> On the other hand, the difference between the two legal systems is only in the original sources. Sharī'ah is based on revealed knowledge (*waḥy*), whereas common law is based on customs of the society, which are gradually established as a system of law. Nonetheless, although Sharī'ah is based on revealed knowledge, it also accepts sources based on customs (*'urf*) and public interest (*maṣlahah*) specifically in instances where the sources of Sharī'ah do not provide any indications (*dalālah*) for the law. However, the application of sources is restricted, as long as they are not contradictory to the universal principles of Sharī'ah law, such as the prohibition of *ribā*, *gharar*, or *maysir*.<sup>337</sup>

In Malaysia, banking and financial matters are regulated under the principles of common law. This is clearly stated in the section 5 of the Civil Law Act 1956 (the CLA 1956) that the law applied to matters of banking, commercial transactions and finance must be the same as applied in England, which is based on common law. This is rein-

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<sup>335</sup> Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh: Edinburgh University Press, 2012), 24-28.

<sup>336</sup> Wael B. Hallaq, "Legal Reasoning in Islamic Law and The Common Law: Logic and Method: The Logic of Legal reasoning in Religious and Non-Religious Cultures: The Case of Islamic Law and The common Law, *Cleveland State Law Review* 79 (1985-1986): 79-96; Donald L. Horowitz, "The Qur'an and the Common Law: Islamic Law Reform and the Theory of Legal Change," *The American Journal of Comparative Law* 42 (1994): 543-580; Wilson, *Legal, Regulatory and Governance Issue*, 24-28.

<sup>337</sup> Mohd Yasin, "Islamic banking in Malaysia," 1-20; Norhashimah Mohd Yasin, "Legal Constraints in Applying Islamic Banking and Finance in 15 Malaysia," (paper presented at Seminar on Islamic Banking Law Students' Society International Islamic University Malaysia, 30 August 2002).

forced in the section 3 of the Act stated that in the absence of the written laws in Malaysia, the applicable laws are the English common laws and rules of equity.<sup>338</sup> It has been argued that common law is capable to regulate the matters of Islamic banking and finance. Mohamad (2009) and Trakic (2013) for example contend that common law has become the applied law to Malaysia after independence and the change to the established legal system requires cost and time to the country.<sup>339</sup> Furthermore, the infrastructure of common legal system has been established in the Malaysian legal system, such as the judges and legal education. To adopt the requirements of Islamic banking and finance, the government has established a harmonization committee at Bank Negara Malaysia to address dissimilarity of common law and to propose to the government to change the law in order to support and facilitate the development of Islamic banking industry.<sup>340</sup>

Nonetheless, it has been observed that the application of Sharī'ah law is too restricted, as it has no power on Islamic banking matters. Sharī'ah law should become the main law of Islamic banking, since it provides all the values and principles for Islamic banking products to maintain its Islamicity and fulfill the objectives of Sharī'ah and Islamic economics. Without Sharī'ah law, the Islamicity of the product is doubtful, since other legal system cannot provide the same standards and measures similar to Sharī'ah. This has created a challenge for Islamic banking industry in Malaysia, as the industry is required to abide the national or common law along with the Sharī'ah legal provisions.

### 3.3. Islamic Financial Services Act 2013

The Malaysian government recently has introduced the Islamic Financial Services Act 2013 (the IFSA 2013) to replace the Islamic Banking Act 1983 (the IBA

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<sup>338</sup> Equity means 'fairness' and is the body of rules developed first by the Lord Chancellor and by the old Court of Chancery in the end of the fifteenth century. Equity, unlike the common law, is not a complete body of rules which can exist on its own and it merely filled the gaps in the common law and softened the strict rules of common law. Law Teacher, "English common law and the rules of equity," accessed on 29 June 2013, <http://www.lawteacher.net/constitutional-law/essays/english-common-law-law-essays.php#ixzz2XUm3VcII>

<sup>339</sup> Abdul Hamid Mohamad, "Interlink/Interface between Civil Law System and Sharī'ah Rules and Principles and Effective Dispute Resolution Mechanism," (paper presented at the Islamic Financial Services Industry Legal Forum 2009, Kuala Lumpur, 28-29 September); Adnan Trakic, "The Adjudication of Sharī'ah Issues In Islamic Financial Contracts: Is Malaysian Islamic Finance Litigation a Solution?" *Humanomics* 29, no. 4 (2013): 260-275.

<sup>340</sup> Ibid.

1983) to support and facilitate the development of Islamic banking and finance.<sup>341</sup> This new Act, which is more detail than IBA 1983, aims to promote better financial stability and compliance with Sharī'ah principles, as well as to ensure the safety and soundness of related activities of the IFIs in Malaysia.<sup>342</sup> The Act also regulates the operations of other financial institutions that deal with Islamic financial transactions. These include *takāful* operators; international Islamic banks; international *takāful* operators; operators of payment systems; issuers of Islamic payment instruments; *takāful* brokers and Islamic financial advisor; payment systems, the Islamic money market as well as Islamic foreign exchange market.<sup>343</sup>

Furthermore, the Act stresses that every product must comply with the rules and principles prescribed by the SACBNM to ensure Islamic banking products are Sharī'ah compliant.<sup>344</sup> All these rules and principles have been compiled in the form of the Sharī'ah resolutions of Islamic finance issued by the BNM as well as Sharī'ah committee appointed by the Islamic banks.<sup>345</sup> Thus, the IFSA 2013 is not regarded as a substantive law for Islamic financial services, but a supervisory law intended to regulate the industry.<sup>346</sup> On the other hand, the substantive laws of Islamic banking are provided by other legislated laws in the federation, such as the Hire Purchase Act 1967, Companies Act 1965, Stamp Duty Act 1949, Securities Commission Act 1993, National Land Code 1965, the Contracts Act 1950, Real Property Gains Tax Act 1967, Sale of Goods Act 1957 and Development Financial Institutions Act 2002, as well as Sharī'ah resolutions made by the SACBNM. The laws provide detailed rules on conventional and Islamic banking products. For example, in order to issue a product based on the

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<sup>341</sup> Aishath Muneza, and Ismail Wisham, and Rusni Hassan, "Clash of Convictions: Conventional Banking vs. Islamic Banking," *Malayan Law Journal* 5 (2010): xi-xxxix; Rusni Hassan, Aishath Muneza and Ismail Azzam Wajeeh. "Legal Obstacles Facing Islamic Banking in Malaysia," *World Journal of Social Sciences* 1, no. 5 (November 2011):126-131.

<sup>342</sup> To ensure its implementation in regulation and supervision, the Act must be recited in parallel with the CBMA 2009, which also provides some provisions related to the operations of Islamic financial services. The CBMA 2009 also provides a discretionary power to the SACBNM to interpret and decide Sharī'ah rules pertaining to Islamic commercial law. As a result of these sections, the SACBNM has a full power to interpret all matters regarding Islamic financial services which can overrule any decision made by the court and the arbitrator.

<sup>343</sup> The section related to Islamic banking in IFSA 2013 is actually derived from the IBA 1983, which was modeled from Banking Act 1973. Thani, *et. al.*, *Law and Practice of Islamic Banking and Finance*, 102.

<sup>344</sup> Section 28 (2) IFSA 2013.

<sup>345</sup> The resolution issued by the SACBNM is prevailed and applied to all Islamic financial institutions, including Islamic banks. See section 57, Central Bank of Malaysia 2009.

<sup>346</sup> The industry of Islamic financial services may include Islamic capital market, Islamic banking and *takāful* activity.

*murābahah* concept, in addition to the Sharī'ah principles of *murābahah*, the product must at least comply with several acts, such as the Contracts Act 1950, Stamp Act 1949, Powers of Attorney Act 1949, National Land Code 1965, Trustees Act 1949, Companies Act 1965, Strata Titles Act 1985, and Housing Development (Control and Licensing) Act 1989, from the beginning of the process of issuing a letter of offer till the termination of the contract.<sup>347</sup>

From the 18 parts listed in the IFSA 2013, only one part addresses the Sharī'ah requirements for Islamic banking products. This part is divided into 3 sections. The first section highlights the duty of IFIs to ensure the compliance of Sharī'ah principles and the power of Central bank to specify standards on Sharī'ah matters. While the second section deals with Sharī'ah governance, which requires for the IFIs to establish Sharī'ah committee and to observe the compliance of its operations and products, the qualifications, duties, cessation, notice of cessation of the Sharī'ah committee members, information to be provided by the IFIs to the Sharī'ah committee and qualified privilege and duty of confidentiality of the Sharī'ah committee. Finally, the third section specifies the responsibility of IFIs to audit their compliance to the Sharī'ah principles concerning to the products and operations as well as the responsibility of person appointed as auditor.<sup>348</sup>

As compared to the previous the IBA 1983, which provided a general connotation of the types of businesses that Islamic bank that can be involved, the IFSA 2013 specifies them in details. It defines Islamic banking businesses are Islamic deposits on current account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid by customers. As compared to the previous act, the Act specifies the types of Islamic deposit (*wadī'ah*), which is a sum of money accepted or paid in accordance with Sharī'ah principles that Islamic banks will be repaid in full, with or without any gains, return or any other consideration in terms of money or money's worth. It also stipulates that the proceeds or gains under the arrangement to be paid to the depositor shall not be less than that sum of money accepted previously. This principle attempts to signify the Sharī'ah principles of *wadī'ah yad damānah* (safekeeping with guarantee/with liability), that it is treated as a loan to the

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<sup>347</sup> See the detail of the act in Hakimah Yaacob, "Analysis of Legal Disputes in Islamic Finance and the Way Forward With Special Reference to a Study conducted at *Mu'āmalāt* Court, Kuala Lumpur, Malaysia," (ISRA Research Paper no. 25/2011, International Sharī'ah Research Academy, 2011)

<sup>348</sup> Part IV, Sharī'ah Requirements, IFSA 2013, 60-67.

bank, where it is not onerous to the bank to pay to the depositor of any compensation. If the bank promises to pay some consideration, it will be conceded as *ribā*<sup>349</sup>

Furthermore, the IFSA 2013 excludes the scheme of Islamic deposit from the type of money to be paid as *bona fide* (undertaken in a good faith), such as an instalment or a part payment under a contract of sale, hire or other provision of property or services. It is only repayable in the event that the property or services are not, in fact, sold, hired, or otherwise provided. The Act also excludes money paid for security of performance of a contract or security in respect of any loss, which may result from the non-performance of a contract or security for the delivery or return of any property.<sup>350</sup> This exclusion of money deposited is also not part of the discussion of Islamic deposit (*wadī'ah*) in Sharī'ah. It also known as *bay' al-'urbūn* (security deposit) for money advanced under a contract for the sale. It also may be included under the provision of *salam* or *istiṣnā'* sale for performance of a contract or security in respect of any loss, which may result from the non-performance of a contract or security for the delivery up or return of any property.<sup>351</sup>

In addition, Islamic bank also may offer other products, such as investment account, provision of finance and other business approved by the Minister of Finance. Investment account is an account under which is paid and accepted for the purposes of investment including for the provision of finance in accordance with Sharī'ah on terms that there is no express or implied obligation to repay the money in full, or entitled profits. Meanwhile, provision of finance is an arranging for another person to enter into the business or activities, which are in accordance with Sharī'ah principles. These include equity or partnership financing (*mushārah*, *mushārah mutanāqishah* and *muḍārabah*), and lease based financing (*ijārah*, *ijārah muntaḥiyah bi al-tamlīk* and *ijārah thumma al-bay'*). Sale based financing is also included one part of the activities (*istiṣnā'*, BBA, *bay' salam*, *murābaḥah* and *musāwamah*). Furthermore, other businesses that can be taken up by Islamic banks are currency exchange, fee based activity, which is *wakālah*, purchase of bills of exchange, certificates of Islamic deposit or other

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<sup>349</sup> BNM, *Sharī'ah Resolutions*, 101-102.

<sup>350</sup> The Act also lists other moneys paid as *bona fide* comprehensively in Schedule 2 of the Act.

<sup>351</sup> For further clarification of *salam* and *istiṣnā'* in the Sharī'ah respectively, one may refer to AAOIFI, *Al-Ma'āyir al-Shar'iyah*, 161-176, 177-198.

negotiable instruments, and the acceptance or guarantee of any liability, obligation or duty of any person.<sup>352</sup>

Besides, the IFSA 2013 also allows derivatives products in the industry. The types of derivatives approved are options, swaps, futures, or forward contracts. The Islamic derivatives products refer to those whose values are derived from the value of something else, such as Islamic securities, commodities, assets, rates (including profit rates or exchange rates) or indices. If the prices of the underlying products fall, the value of derivatives products also will fall.<sup>353</sup>

Islamic bank also may involve in Islamic factoring business. It is the business of acquiring debts or other financial obligations from any person arising from any transaction based on Sharī'ah principles as well as Islamic foreign exchange market. Furthermore, Islamic bank also may involve Islamic leasing business or sub-leasing movable property on hire for specific purposes. For example, the use of such property by the hirer or any other person for the purpose of any business, trade, profession or occupation or in any commercial, industrial, agricultural or other economic enterprise whatsoever where the lessor is the owner of the property. This is regardless of whether the leasing is with or without an option to purchase the property. The property that can be leased out is the type of movable property, which may include any plant, machinery, equipment or other chattel attached, or to be attached to the earth or fastened or to be fastened, permanently or otherwise, to anything attached to the earth. Another business opportunity that Islamic banks may take part in is a service of payment, where the banks may devise any instrument, whether tangible or intangible, which would enable a person, who applies for the service, to obtain money, goods or services or to make any payment on his behalf.<sup>354</sup>

Having explained of the features of the Act, it is observed that there are some inadequacies of essential elements that the Act fails to highlight. The main concern of the Act is to ensure the Sharī'ah compliance; however, it does not address any Sharī'ah legal ruling about the principles of Sharī'ah, such as the principles of Islamic contract law, and the prohibition of *ribā*, *gharar* and *maysir*, which are very important to determine the Islamicity of Islamic banking and financial products. The emphasis of the Act is only on the procedural matters for the bank to ensure its compliance with the

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<sup>352</sup> Section 2, "interpretation" of IFSA, 33.

<sup>353</sup> "Interpretation", IFSA, 30.

<sup>354</sup> . Section 2, "interpretation" of IFSA, 32-33.



Sharī'ah by following the decisions made by the Sharī'ah board.<sup>355</sup> All essential components of the contract are decided by common laws system. However, some of these laws are mismatched with the Sharī'ah principles. For example, in the case of option, the law adopted the concept of *caveat emptor*, which emphasizes that the buyer is obliged to discover the truth about the item to be purchased by exercising ordinary diligence, prior to the contract is taking place. This means that if the buyer enters into a contract, without examining the goods with ordinary diligence, the contract is regarded as valid and he is not entitled to the right of option.<sup>356</sup> However, this is different with the rule of option in Sharī'ah, where the seller is required to disclose the defect of the sold item, and if it is not revealed, the buyer has a right of option, namely *khiyār al-tadlīs* (option of fraud) or *khiyār al-'ayb* (option of defect)<sup>357</sup>

Furthermore, the Act only explains very minimal on the rules and the parameters of contracts that are currently practiced in Islamic banking, such as *muḍārabah*, *mushārah*, *murābahah*, *istiṣnā'* or *salam*. This allows a problem to the practitioners since it is not conclusive for them to refer which law to be applied. They cannot refer to other Sharī'ah standards issued by other Sharī'ah boards, for example those issued by the AAOIFI's Sharī'ah standards or resolutions issued by the IFAOIC or other decisions made by Sharī'ah boards of other Muslim countries, since their resolutions and jurisdictions are not applicable to the Malaysian legal framework.

The Act also allows trading of derivatives securities, which have been rejected by most Sharī'ah jurists especially in the Middle East as well as Sharī'ah scholars from the AAOIFI and IFAOIC.<sup>358</sup> The reason for this opposition is that they are based on pure gambling and that it creates fictitious transactions that exchange something that does not exist. Options, for example involve a transaction, where its subject matter is not an asset that can be accepted in accordance to Sharī'ah. Swaps are also prohibited due to the absence of an actual exchange of counter values, which lies on interest pay-

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<sup>355</sup> This is clearly stated in the act, "an act to provide for the regulation and supervision of Islamic financial institutions, payment systems, and other relevant entities," see IFSA 2013, 19.

<sup>356</sup> Mohd Affandi Awang Hamat, "*The Theory of Option (Al-khiyar) in Islamic and Malaysian Laws: A Comparative Study*," (PhD diss., International Islamic University of Malaysia, 2004), 109.

<sup>357</sup> Ibid, 97-98.

<sup>358</sup> Muhammad Hashim Kamali, "Islamic Commercial Law: An Analysis of Futures", *The American Journal of Islamic Social Science* 13, no. 2, (1996) 197-224; Muhammad Akram Khan, "Commodity Exchange and Stock Exchange in an Islamic Economy," *The American Journal of Islamic Social Sciences* 9, no. 1, (1988) 91-114; Muhammad Fahim Khan, *Islamic Futures and Their Market*, Islamic Development Bank, IRTI, Jeddah; AAOIFI, *Al-Ma'āyir al-Shar'iyah*, 359-372.

ment, involving *bay' al-ṭinah* transaction and deferment of one of the counter values.<sup>359</sup> However, Malaysian Sharī'ah jurists defend derivatives products as valid in the Sharī'ah, since they are based on genuine value of the underlying product. For example, the SACBNM has approved Islamic Profit Rate Swap Based (IPRS) on *bay' al-ṭinah*, which is considered as one type of Islamic derivatives' products. The council argues that IPRS's structure is permissible and is not tantamount to the sale of debt with debt (*bay' al-kālī bi al-kālī*), which is prohibited by the Sharī'ah.<sup>360</sup> This creates a challenge for Islamic banking and banking to harmonize between the requirement of Sharī'ah and conventional finance in order to face competitive financial landscape.

### 3.4. Sharī'ah Advisory Council and Sharī'ah Resolutions

Sharī'ah Advisory Council (SAC) or Sharī'ah Supervisory Board (SSB) is the highest Sharī'ah board that interprets Sharī'ah law. It is an independent body of specialized jurists in *fiqh al-mu'āmalāt*, as well as other expertises such as economists and finance. The board is entrusted with the duty of directing, reviewing, and supervising the activities of the Islamic financial institution. Every *fatwā* or legal opinion and ruling issued by the board must be binding by the industry.<sup>361</sup> Sharī'ah board is very important to convince the customers that all operating elements including products and services of the bank complies with the Sharī'ah principles. This board carries out fiduciary duties to protect the rights and interests of all stakeholders in the bank.

The number of the advisors normally depends on the jurisdiction of the bank. The AAOIFI, for example, recommends three members and one of the members must reside in the country that the bank operationalizes. The main role SAC is to advise and monitor the bank's product and operation to the Sharī'ah precepts and then report the results to the BoD of the bank. The integrity of Islamic banking products is greatly dependent on status of Sharī'ah compliance, the impact of products, professional compe-

<sup>359</sup> Islamic Fiqh Academy, *Resolutions and Recommendation*, 131-133,

<sup>360</sup> For further information regarding the structure of the product, see BNM, *Sharī'ah Resolutions*, 139-143.

<sup>361</sup> Accounting and Auditing of Islamic Financial Institutions (AAOIFI), *Auditing and Governance Standards for Islamic Financial Institutions Governance Standard* (Manama, Bahrain: AAOIFI, 2005), 5.

tence, and behaviour towards and observance of Sharī'ah norms.<sup>362</sup> In Malaysia, SSB is normally known as Sharī'ah Advisory Council (SAC).

Generally, a Sharī'ah board has five functions, namely certifying financial instruments for their compliance with the Sharī'ah, verifying transactions for compliance with the Sharī'ah, calculating *zakah* payable, disposing of non-Sharī'ah compliant income, and advising on the distribution of income among investors and shareholders.<sup>363</sup> In this respect, the IFSB (2009) has developed five guiding principles to regulate the Sharī'ah governance system of SAC. Among others, it deals with various *ex-ante* and *ex-post* processes considered as essential parts of good governance's practices internationally recognised, such as Sharī'ah board, appropriate alignment of incentives; proper record keeping, or adoption of a professional code of ethics. The principles also outline the area of competence recommended of the Sharī'ah advisors and various measures to ensure reasonable expertise and skill-sets in Sharī'ah boards, and to evaluate their performance and professional development. In order to safeguard the independence of the Sharī'ah boards, especially from the influence of bank's management, the standard highlights various issues arising from potential conflicts of interest and recommendation to solve the problem. Furthermore, Sharī'ah members must uphold the confidentiality of the internal information during the course of undergoing their duties. The board also must interpret consistently the Sharī'ah rules based on the discipline of *fiqh al-mu'āmalāt*, as far as possible to reach a consensus about the Sharī'ah issues and if they cannot reach to unanimous decision, the board must decide on the issue based on the simple majority.<sup>364</sup>

In the Malaysian context, SAC plays an important role to regulate Islamic banking industry. In this respect, the main functions of SAC are observing the operational aspects; approving products; monitoring the Sharī'ah compliance of the products; as well as reviewing and auditing all aspects of the operations of the bank, which is SACBNM. The council was established in 1997 by BNM, as the highest authority in resolving Sharī'ah issues concerning Islamic banking and *takāful* issues. In this respect, the members of the council comprise of an expert in *fiqh al-mu'āmalāt* and Sharī'ah

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<sup>362</sup> Ayub, *Understanding Islamic Finance*, 467.

<sup>363</sup> Wafik Grais and Matteo Pellergrini, "Corporate Governance and Sharī'ah Compliance in Institutions offering Islamic Financial Services," *Policy Research Working Paper 4054*, November, 2006, Washington, DC, the World Bank. 1-38

<sup>364</sup> Islamic Financial Services Board (IFSB), "Guiding Principles on Sharī'ah Governance Systems for Institutions offering Islamic Financial Services," 1-39, accessed on 4 May 2013, [www.ifsb.org](http://www.ifsb.org).

law, as well as economic and finance subject. The appointment of members of the SACBNM shall be made by the Supreme Head of Malaysia on the advice of the Minister of Finance after consultation with the Central Bank.<sup>365</sup>

The Central Bank of Malaysia Act (2009) has been amended in order to strengthen the role of SAC at the national level. The act delineates in details the functions of the SACBNM.<sup>366</sup> In this respect, SACBNM has a power to determine the legal ruling on Islamic financial services. The Act stresses that the court or arbitrator shall take into consideration any published rulings of the SAC for its ruling before deciding any cases. The court and arbitrator are also required to refer to SACBNM to obtain advice or legal ruling pertaining Sharī'ah principles. Under the section 56 of the Act, it also provides that any decision made by the SAC is binding on the IFIs. The impact of the above provisions on the Islamic financial industry is that the court of law and arbitrators shall refer all Sharī'ah matters and issues related to Islamic financial services to the SAC. This is however has not happened in previous the IBA 1983, and the court of law and arbitrators are not obligated to refer with the SACBNM's resolutions in order to adjudicate Islamic banking cases.<sup>367</sup>

Among the function of SACBNM is to discuss the issue raised by Islamic financial institutions regarding Sharī'ah rules. In this respect, the council has compiled resolutions or *fatāwā* in a book regarding Islamic financial issues. The book consists of resolutions on *ijārah*, *istisnā*, *mudārabah*, *mushārah*, *qard*, *rahn*, *takāful*, *tawarrūq*, *wadī'ah*, *wakālah*, *bay' al-dayn*, *bay' al-īnah*, *hibah*, *ibrā*, as well as *ta'wīḍ* and *gharamah*. The resolution also addresses the issue of new Islamic financial products, namely financial derivative instruments, Islamic credit card, hybrid products, and *ṣukūk* based on *bay' bithaman ajīl*. In addition, it also highlights Sharī'ah issues related to the operations of supporting institutions in Islamic finance, such Credit Guarantee Corporation (Malaysia) Berhad, Danajamin Nasional Berhad, Malaysia Deposit Insurance Corporation, and National Mortgage Corporation. Finally, the resolution also focuses on various issues in Islamic finance, such as winding up of Islamic banking institutions,

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<sup>365</sup> Aznan Hasan, *Fundamental of Sharī'ah in Islamic Finance* (Kuala Lumpur: IBFIM, 2011), 174.

<sup>366</sup> In Malaysia, Sharī'ah Supervisory Council is known as Sharī'ah Advisory Council. The latter will be used specifically when it is referred to the Malaysian case.

<sup>367</sup> Section 56 and 57, Central Bank of Malaysia Act (2009).

accounting and reporting standards in Islamic finance, as well as other related issues to Islamic finance.<sup>368</sup>

In a few recent studies, however, the independence and integrity of SAC have been questioned by scholars.<sup>369</sup> For example, Sheikh Hassan (2012) addresses the issue of weaknesses and shortcomings of the Shari'ah board particularly, the knowledge and experience of its members. He asserts that members of Shari'ah boards are lacking of banking's experience, especially about the modern concept of banking. Their mediocre knowledge meant they could hardly participate in discussions about the new products presented to them.<sup>370</sup> Furthermore, the author stresses that Islamic banks face the difficulty in finding Shari'ah expertise in accounting and finance. Moreover, most members of the Shari'ah board seemed to depend on the research done by Shari'ah department established in the banks in order to give their opinion about the product, instead of their independent research.<sup>371</sup> Furthermore, it is also found Islamic banks adopt the *ta-khayyur* (selective opinion) purposely to protect the interest of the bank. In this respect, the department responsible for justifying and presenting the product only uses Shari'ah opinions that support its product and would neglect other opinions, which are contrary. The study also discloses that the management of the Islamic bank only asks the Shari'ah board to supervise the product only and not the overall activities of the bank. Furthermore, the management of Islamic banks also tends to influence the decision of Shari'ah board, where at the initial stage probably the product is not approved, but when the management gets involved, the decision would be otherwise. The Shari'ah board itself does not attempt to undertake its roles and functions professionally, as it is supposed, while, the management attempts to justify profit as the main objective at any rate, although it will dent some elements of the Shari'ah compliance. Consequently,

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<sup>368</sup> See *Shari'ah Resolutions on Islamic Finance* (Kuala Lumpur: BNM, 2010).

<sup>369</sup> See criticisms of Shari'ah boards, for example Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2010), 236; Grais and Pellergrini, "Corporate Governance and Shari'ah Compliance," 1-38; Mohammad Nejatullah Siddiqi, "Shari'ah, Economics and the Progress of Islamic Finance: The Role of Shari'ah Experts," (paper presented at Selected Ethical and Methodological Issues in Shari'a-Compliant Finance Seventh Harvard Forum on Islamic Finance, Cambridge, Massachusetts, USA Friday 21 April 2006); Murat Ünal "The Small World of Islamic Finance. Shari'ah Scholars and Governance - A Network Analytic Perspective," accessed on 1 May 2013, [http://www.funds-at-work.com/uploads/media/Sharia-Network\\_by\\_Funds\\_at\\_Work\\_AG.pdf.pdf](http://www.funds-at-work.com/uploads/media/Sharia-Network_by_Funds_at_Work_AG.pdf.pdf); Ahmad Alkhamees, "The Impact of Shari'ah Governance Practices on Shari'ah Compliance in Contemporary Islamic Finance," *Journal of Banking Regulation* 14 (April 2013):134-163.

<sup>370</sup> Sheikh Hassan, "An Empirical Investigation," 315-318.

<sup>371</sup> Ibid.

this would undermine the independence and accountability of Sharī'ah board in carrying their task.<sup>372</sup>

Furthermore, it is observed that the reliance to the resolutions is insufficient to cope with the complexity of Islamic banking industry. In this respect, the nature of the *fatāwā* is only to provide a brief answer to the questions asked by the practitioners. Typically, *fatwā* is an Islamic legal opinion given by the *muftī* (jurist-consult), as a response to a question. The nature of *fatwā* is only to answer the related issues of the question and tends to escape other essential elements of the issue asked, although they are important. Whereas, the scope of Sharī'ah requirements to determine the validity and Islamicity of a contract is very wide and comprises of the pillars, conditions, valid and invalid contracts, and the prohibitions. Thus, *fatwā* could not be the only solution to every single case faced by IBIs, due to the limitation of the nature of *fatwā*. Furthermore, the resolutions are also not gazetted as law to regulate Islamic banking matters, which result for the disputed parties have to rely on the common law system. Beside the resolutions, the BNM also issued four Sharī'ah parameters to accommodate the complex procedures of Islamic commercial law; namely *murābahah*, *ijārah*, *mushārah*, *muḍārah* and *istiṣnā'*. Among the matters highlight in the parameters are the concept and how it can be applied in developing Islamic banking products. However, the inadequacy of the parameters, as compared to Sharī'ah standards issued by the AAOIFI is that the parameters do not address any Sharī'ah justifications or rationales why certain rules are adopted.<sup>373</sup>

Furthermore, the dependence on the resolutions issued by the Sharī'ah advisory committee appointed by the bank is also insufficient in resolving the substantive issues of Islamic legal rulings. The resolution made by the committee's members is depended on the strong arguments and justifications made by the Sharī'ah officer that presents the case to them. If the presentation fails to address some important issues of the structure, then the product will not be approved by the committee. If the product is a new case to the committee member, they have to discuss rigorously the structure of the product, be-

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<sup>372</sup> Zulkifli Hasan, "Sharī'ah Governance in Islamic Financial: Institutions in Malaysia, GCC Countries and The UK," (PhD diss., University of Durham, 2011), 343-345.

<sup>373</sup> See Bank Negara Malaysia, "Sharī'ah Parameters," accessed on 20 July 2013, <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>; see also criticisms of Sharī'ah Parameters issues by the BNM by Noraziah Che Arshad and Abdul Ghafar Ismail, "Sharī'ah parameters for Mushārah Contract: A comment," *International Journal of Business and Social Science*, 1, (1) (October 2010): 145-162; Bank Negara Malaysia, "Sharī'ah Parameter Reference 1 – Murābahah," accessed on 1 October 2013, <http://www.bnm.gov.my>; . Muneeza, *et. al.*, "The Paradox Struggle," 188-224.

fore approving it. It is not sufficient for Sharī'ah officers to depend on the general resolutions issued by the SACBNM, but he/she must take into consideration other opinions, such as different legal opinions from different *madhāhib* to support the contract applied for the product. In order to ensure that the product is approved, there is a tendency for the officer to adopt the opinions that only support the contract and escape other opposing opinions of Muslim jurists.<sup>374</sup>

### 3.5. Sharī'ah Governance System

The decision made by the SAC is very important, as it will affect the interest of various stakeholders. The SAC has power to terminate or correct contracts that are found to be contrary to the Sharī'ah principles. If there is no authority to monitor and review the decisions made, then they will jeopardize or threat various interests of stakeholders. Therefore, a framework, namely Sharī'ah governance system has been established in order to ensure the independence and integrity of the SAC in making its legal decisions. It involves structures and processes must be adopted by stakeholders in the IFIs to ensure compliance with Sharī'ah rules and principles. SAC is required to issue Sharī'ah pronouncements appropriately with rigorous deliberation and contemplation of the issues asked by the bank. Once the pronouncements are made, the bank should implement all the legal opinion. It is also the responsibility of the bank to disseminate the pronouncements to the operative personnel, who would monitor the day-to-day compliance with the Sharī'ah. In addition, an internal Sharī'ah audit and review must be appointed to verify each transaction is free from the prohibited elements to the Sharī'ah. If there are, the department should record, report, address, and rectify the issue. In addition, an annual Sharī'ah compliant review/audit also should be exercised by the internal Sharī'ah review/audit to ensure that the bank has complied with the Sharī'ah and its results have been duly noticed by the Sharī'ah board. The board must

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<sup>374</sup> Ahmad Fahmi Sheikh Hassan, "An Empirical Investigation into the Role, Independence and Effectiveness of Sharī'ah Boards in the Malaysian Islamic Banking Industry (PhD diss., University of Cardiff, 2012), 197.

report the results in its annual report on the level of the compliance of the IFIs to the Sharī'ah.<sup>375</sup>

In this respect, IFSB (2009) also delineates guiding principles for professional ethics and conduct to ensure that the board carry its task in due diligence. Each member appointed to the board must sound moral character as well as demonstrate competence and capability, not only about Sharī'ah, but also about the technical requirement of the banking business, the inherent risk therein and the management processes required for conducting its operations effectively. Furthermore, SAC should also demonstrate an independent supervisory role, with sufficient capacity for objective of decision-making on Sharī'ah matters. The IFIs in this respect should provide adequate, complete, specific, and timely information to the board/council to facilitate the decision-making process. Each member of the Sharī'ah board must ensure that internal information obtained during his duties as a Sharī'ah advisor is kept confidential. Finally, the interpretation, judgement, and decision based on *fiqh al- mu 'āmalāt* must be competent, independent, and ethical.<sup>376</sup>

In a similar vein, the BNM also issued a Sharī'ah governance framework comparable to the IFSB's four guiding principles of competence, independence, confidentiality, and consistency.<sup>377</sup> However, what is stressed out by the BNM is the Sharī'ah compliance and research function. In order to ensure Sharī'ah compliance, three processes, namely Sharī'ah review, Sharī'ah audit and Sharī'ah -compliant risk management must be undertaken. According to the BNM's framework, Sharī'ah review refers to the regular assessment of Sharī'ah compliance of the activities and operations of the IBIs by qualified Sharī'ah officers. Meanwhile, Sharī'ah audit signifies independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IBIs' business operations. Its main objective is to ensure a sound and effective internal control system for Sharī'ah compliance. In addition, Sharī'ah -compliant risk management denotes a function to systematically identify, measure, monitor, and control Sharī'ah non-compliant risks to mitigate any possibility

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<sup>375</sup> IFSB, "Guiding Principles On Sharī'ah Governance Systems For Institutions Offering Islamic Financial Services," 2-3, accessed on 28 August 2013, [www.ifsb.org](http://www.ifsb.org)

<sup>376</sup> A member of SAC/SSB must uphold the professional ethics, as follows, independence, personal responsibility, care and conscientiousness, confidentiality, alignment of activities, disciplinary sanctions and post-qualification education. Ibid., 11-39.

<sup>377</sup> Bank Negara Malaysia, "Sharī'ah Governance Framework for Islamic Financial Institutions," accessed on 28 August 2013, [www.bnm.gov.my](http://www.bnm.gov.my).



of non-compliance. The systematic approach of managing Sharī'ah non-compliant risks will enable the IBIs to continue its operations and activities effectively without exposing the IBIs to unacceptable levels of risk. On the other hand, Sharī'ah research highlights the need to establish an internal unit comprising of qualified Sharī'ah officers to conduct pre-product approval process, research, vetting of issues for submission, and undertake administrative and secretarial matters relating to the Sharī'ah Committee.<sup>378</sup>

Notwithstanding, the aspect of Sharī'ah governance in Malaysia also has been criticized. Hasan (2011) for example argued that majority of IFIs did not evaluate the competence of Sharī'ah boards. Some competence' performance is only evaluated through the attendance of Sharī'ah board meeting. There is no an established practice of IFIs to assess or evaluate the Sharī'ah board's performance.<sup>379</sup> Furthermore, some Sharī'ah scholars lack sufficient understanding of the actual meaning of independence in the context of Sharī'ah boards. They failed to differentiate between independence, professional independence and practitioner independence.<sup>380</sup> Independence is very important to maintain a proper attitude toward planning, performance, and reporting when conducting their functions and to avoid any appearance, which may negate the perception of independence. Furthermore, any element that may negate the public perception of its independence, such as the method of appointment, must be eliminated. At this point, the method of appointment should be one of the main elements to ensure professional and practitioner independence as it involves the public perception of and stakeholders' confidence in the IFIs.<sup>381</sup>

Furthermore, it was found that there is conflict of interest as many Sharī'ah scholars sit on various boards of IFIs in the industry. In this respect, Sharī'ah scholars argue that they were bound by Islamic ethical principles. They nevertheless agreed that there should be limits to such a practice not because of conflict of interest but due to time constraint and it would be resolved by overcoming the shortage of Sharī'ah scholars. However, it can be argued they also exposed to mistakes, as they are human beings. Conflict of interest may happen when they sit on the boards of numerous IFIs. In order to avoid this problem, Hasan (2011) recommends that there must be certain restrictions on many appointments of Sharī'ah scholars in Sharī'ah boards. This is purposely to

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<sup>378</sup> Ibid., 23-25.

<sup>379</sup> Ibid., 240

<sup>380</sup> The independence of the Sharī'ah board refers to practitioner independence and professional independence. Ibid.

<sup>381</sup> Ibid., 246.

avoid the issue of conflict of interest and to ensure the Sharī'ah board can perform its functions effectively.<sup>382</sup>

Hasan (2011) also found that Sharī'ah scholars also rarely access to all documents, information, and records that they require for their supervision and verification to ensure Sharī'ah compliance. In practice, they primarily rely on the document presented to them rather than that they proactively examine it. Sharī'ah scholars put their trust in the department that provides all the documents and expect that they will not hide any information of the product. This position indicates that decisions made by Sharī'ah scholars may be determined by the way the IFIs present the documents.<sup>383</sup>

Given the above studies, the role of Sharī'ah advisors is not restricted only to screen the document or legal structure of product, but also to observe the whole operation of Islamic banks to ensure that the banks are Sharī'ah compliant. This must be performed through transparent, accountable and integral process delineated in the Sharī'ah governance framework. The ultimate objective of Sharī'ah governance is to keep the interest of the depositor and stakeholder's money enhances social justice and welfare in Islamic economic system.

### **3.6. Court Jurisdiction of Islamic Banking**

The appropriate court to adjudicate Islamic banking cases is Sharī'ah courts, since the matters of Islamic banking require judges that have knowledge in Sharī'ah law. However, in Malaysia, the civil courts are responsible to adjudicate the cases of Islamic banking, as the country practices the common legal system. This has raised many legal complexities in terms of Islamic law's procedures and civil court's legal system, since some of the elements of the two legal systems contradict with each other. There are two statutes that restrict the matters of banking and finance from being adjudicated in the Sharī'ah courts. Firstly, the CLA 1956 requires the judges to refer to the common law system for commercial, banking and business matters. Secondly, the restriction of the Federal Constitution binds all matters of finance under the Federal list. In this respect, the jurisprudence of Islamic matters is under the Ninth Schedule of the law, which is under the state's jurisdiction. The federal constitution is the highest law in Ma-

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<sup>382</sup> Ibid., 246.

<sup>383</sup> Ibid., 248-249.

Malaysia and any laws contrary to the federal constitution are regarded as null and void. It has limited the scope of Sharī'ah, which are related to the customs of Malay practices and personal matters, such as marriage, inheritance and will, whereby excluding economic and financial transactions, which are also part and parcel of Islamic law.<sup>384</sup>

In this respect, Sharī'ah courts do not have any legal jurisdiction over the Federal list, since they are the matter of each state in the federation. The courts have jurisdiction only over persons, who are professing the religion of Islam on the matter of personal rights, such as marriage, will, and inheritance. Furthermore, Sharī'ah courts are under the jurisdiction of state in the Malaysia and each state has its own Sharī'ah courts, whereas civil courts are under the federal list and applied to all states. Although Sharī'ah courts have its own jurisdiction concerning criminal and civil matters, but the power to adjudicate these matters is very limited. The scope of criminal jurisdiction for the courts is limited to criminal offences that do not exceed the sentence of three years imprisonment, a fine of RM5, 000 and six strokes, or a combination of these punishments.<sup>385</sup> Although the Sharī'ah courts are given the power to adjudicate cases involved in the civil cases, however, they are restricted to hear cases that involve the affairs of Muslims within the scope provided in the List II (State List) of the Ninth Schedule mentioned in the federal constitution. Nonetheless, the federal constitution gives some freedom to the Sharī'ah courts in Article 121 (1A) of the constitution that the Civil Court shall not interfere with matters of the Sharī'ah courts.<sup>386</sup>

Furthermore, Hamid (2009) argues that Sharī'ah courts could not adjudicate Islamic banking cases, as many related laws, such as; bankruptcy law, companies' winding up laws, and land law are outside the jurisdiction of the Sharī'ah courts. He further adds that the Sharī'ah judges also are not conversant to related civil laws, since they are trained in personal laws, such as marriage, and inheritance. In addition, the consistency in judgements by the Sharī'ah courts is very hard to achieve as they are under the jurisdiction of state, which have 14 Sharī'ah courts and 14 appeal courts operating independently. This is different to Federal Court, which has only one court in civil court system and one appeal court. Moreover, the issues, such as, choice of the forum, service of the court's process, and execution of judgments would be common in Sharī'ah courts as there are geographically State courts. Additionally, corporate lawyers who are

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<sup>384</sup> Engku Ali, "Constraints and Opportunities in Harmonisation of Civil Law and Shariah" i - xxxvii.

<sup>385</sup> Markom, *et. al* (2011), *Kerangka Perundangan*, i-xxxiii.

<sup>386</sup> Lateh, *et. al.*, "The legal framework of the Islamic financial System, 85-97

not Sharī'ah lawyers would not be able to appear in the Sharī'ah courts, since they have no qualification to enter the courts. Besides, the documents are drafted by common law lawyers in English, following common law precedents, and the Sharī'ah courts are not familiar with them. Finally, there will be an issue in relation to reciprocal enforcement of judgements of Sharī'ah courts, as the current Reciprocal Enforcement of Judgements Act 1958 only applies to the judgments of civil courts.<sup>387</sup>

On the other hand, it has been argued that the adjudication of Islamic banking cases by civil court's judges has created legal disorder in the Islamic banking industry. Jamal (2010) contends that the civil court's judges are not competent to Sharī'ah law, as most of them are trained experts in common legal system but not in Sharī'ah law.<sup>388</sup> Civil court's judges also never use the principles of Islamic law in deciding Islamic banking cases, since they are not competent to the law. Furthermore, in common legal system, the judges may apply the principles of equity or create a new legal precedent case, if the cases that they adjudicate are new cases to the court. This gives probability that the judges may employ Islamic law principles, as Islamic banking and financial matters are new to them. However, the judges are reluctant to change the system, since most of them are bound to the Civil Act 1957 and lack of knowledge of Sharī'ah law. As a result, they could not justify their legal reasoning by using the sources of Islamic legal system. In addition, the Malaysian legal system does not provide specific references or the equivocal statutes of Islamic legal substantives. Consequently, they could not make an accurate judgment that conforms to the Sharī'ah principles and objectives.

The above issues can be illustrated through a few legal decision made by the civil courts' judges, where they failed to reason their legal decision in accordance with the principles of Sharī'ah. For example, in the case of *Bank Islam Malaysia Berhad versus Adnan b. Omar*, the judge regarded BBA, as a loan, failing to see that it is a sale transaction with deferred payment. The use of loan term deviates from the original principle of loan in Sharī'ah. In loan transaction, if there is an increase from the principal, it is considered *ribā*, while any increase in sale transaction, it is considered as profit, and it is permissible. The judge also decided that Sharī'ah courts only have the power over the believers of the Islamic religion. However, as Islamic bank is a corporate entity, which has no religion, hence, the Sharī'ah courts do not have power to adjudicate

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<sup>387</sup> Mohamad, "Interlink/Interface between Civil Law System and Sharī'ah Rules and Principles; Trakie, "The Adjudication of Sharī'ah Issues," 260-275.

<sup>388</sup> Jamal "Sistem Kewangan Islam di Malaysia," 179-196.

the case. The relevant law under constitutional law is commercial law, which is under the provision of federal statutes and English law. The judge did not refer to any Islamic legal substance, when he decided the case.<sup>389</sup>

In another disputed case between *Tinta Press Sdn. Bhd. versus Bank Islam Malaysia Berhad* involving *ijārah* contract, the judge evaluated the cases from the perspective of lease contract in conventional law, without referring to any legal concept of *ijārah*. It is unfortunate case, when the first document drafter between the bank and its customer; they made it in accordance to the principles of Sharī‘ah endorsed by Sharī‘ah advisory board. When they disputed about the terms and conditions of the facility, the law relied on a conventional law of lease.<sup>390</sup> Furthermore, some judges do agree with the concept and principles applied in their legal rulings of Islamic banking cases; however, they are unable to refer to the original sources of the principle applied for the contract. For example in the case between *Dato’Haji Nik Mahmud bin Daud versus Bank Islam Malaysia Berhad*, which was also related to the application of BBA, the judge did not refer to the contract as applied in Islamic banking, instead he referred to the contract as was applied in other written statutes of common law in Malaysia. The judge also indicated that there is no transfer of ownership, from the plaintiff to the defendant and that the process of the transfer of ownership is regarded as “procedural arrangement” to complete the required process in Islamic legal documentation.<sup>391</sup> In the case of *Bank Islam Malaysia Berhad versus Shamsuddin bin Haji Ahmad*, the judge used the term of interest in loan transaction, whereas, the concept applied in the contract was BBA.<sup>392</sup> In the case of *Tahan Steel Corporation Sdn Bhd versus Bank Islam Malaysia Bhd* involving *istiṣnā’* facility, the judge again did not to refer any concept of *istiṣnā’* in Islamic banking, but the judge referred to other statutes of common legal system and failed to appreciate the relevancy of Islamic law in his judgement.<sup>393</sup>

Nonetheless, the landmark case to indicate the inadequacy of civil courts’ judgements to explain the principles and rules of Sharī‘ah contract can be obviously seen in the case *Arab-Malaysian Finance Bhd (plaintiff) versus Taman Ihsan Jaya Sdn Bhd and Ors (defendant)*. In this case, the presiding judge decided that a product based on BBA

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<sup>389</sup> Bank Islam Malaysia Berhad v Adnan Omar (1994) 3 CLJ 735; (1994) 3 AMR 44; (1994) 4 BLJ 372.

<sup>390</sup> Tinta Press Sdn Berhad v Bank Islam Malaysia Berhad (1987) 1 MLJ 474; 1 CLJ 474.

<sup>391</sup> Dato’ Nik Mahmud Bin Daud v Bank Islam Malaysia Berhad (1996) 4 MLJ 295.

<sup>392</sup> Bank Islam Malaysia Bhd v Shamsuddin Bin Haji Ahmad (1999) 1 Legal Network Series (LNS) 275; (1999) MLJ 450.

<sup>393</sup> Tahan Steel Corporation Sdn Bhd v Bank Islam Malaysia. Berhad (2004) 6 CLJ 25; (2004) 6 MLJ 1.

is not a bona fide sale but a financing transaction or loan transaction, which rendered the profit gained under the *ribā*-like financing scheme as contrary to the IBA 1983 or the Banking and Financial Institutions Act 1989 ('the BAFIA').<sup>394</sup> The judge contended that it is a financing facility, similar to conventional loan financing product; hence, it is under civil jurisdiction, where it must be evaluated under the common law system and not under the Sharī'ah courts. The product is also evaluated as to whether the contract applied therein is consistent with the Sharī'ah, as clearly stated in the IBA 1983. The judge claimed there are no laws or statutes in the federation in which the court may refer to interpret the contract. The IBA 1983 only provides a general provision that the aims and operations of the bank shall not be contrary with any elements that are not approved by the Islamic religion. However, the Act did not elaborate in detail all the provisions and rules related to BBA contract. The judge was of the opinion that it is his responsibility to interpret the contract so that it does not contravene with the Islamic religion<sup>395</sup>

Furthermore, the judge was also of the opinion that there is no specific Islamic legal school (*madhhab*) prevailed in the interpretation of Islamic religion. What was important, according to the judge, was that the product must not involve any elements that are not approved by religion of Islam as interpreted by any of the recognized *madhāhib*, and if any particular school had forbidden the transaction, then it was sufficient for the court to prohibit it.<sup>396</sup> Furthermore, the judge also attempted to interpret the meaning of *ribā*, by comparing loan and a bona fide sale transaction. According to the judge, the prohibition of *ribā* in the religion of Islam is excessive hardship hence he sees that the profit taken by Islamic bank causes hardship to the buyer to pay it and is significantly higher than conventional loan. The judge concluded that since the profit by the bank is higher than normal conventional interest then the product should not be approved in the Islamic religion.<sup>397</sup> The consequence of the judgment is that the plaintiffs were not entitled to claim the profit of the sale. Instead, the court ordered that the plaintiffs were only entitled to claim for the purchase price (original price) and the

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<sup>394</sup> Fakihah Azahari "Islamic Banking: Perspectives on Recent Case Development," *Malaysian Law Journal* 1 (2009): xci- cxxviii; Abdul Wahab Patail, "Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)," *Malaysian Law Journal* 5 (2008): 631-660; Azahari "Islamic Banking," xci- cxxviii.

<sup>395</sup> Mohd Yasin, "Islamic Banking," 1-20

<sup>396</sup> "Azahari "Islamic Banking," xci- cxxviii.

<sup>397</sup> Ibid.

judge viewed that his opinion is an equitable interpretation.<sup>398</sup> Besides, the judge also maintained that its judicial function was to apply the Islamic principles in Islamic transactions in such a way as to ensure that the transactions are implemented in accordance with the Islamic religion. Hence, in exercising this function, the judge opined that it was not necessary for him to refer to the resolution provided by SAC for advice. This is because there were no statutes or laws that required the court to be bound to their legal advice.<sup>399</sup>

Since the judge ruled the contract is void; therefore, section 66 of the Contracts Act 1950 is applied.<sup>400</sup> Therefore, the defendant is only required to pay the purchase price and not the profit to the plaintiffs. The impact of the ruling is that it will endanger the whole industry. The consequence of this decision is that it would change the current practices of Islamic banks and financial institutions in requesting for the balance sale price when a default occurs. Hence, this will deny Islamic banks and financial institutions from claiming their profit based on the BBA financing facilities.<sup>401</sup> Islamic bankers also feared that the judgment could mean the current BBA financing clients would only need to pay the facility amount, not honour the profit portion. This would cost Islamic banks billion of Malaysian ringgit, since most the financing facilities in Malaysia are operated under the BBA concept.<sup>402</sup> The judgment also will lead to prohibition of other Islamic banking products that are developed and structured on the same edifice, such as *bay' al-ṭinah*, *tawarrūq*, *murābahah lil amr bi al-shirā*, *ijārah muntahiyah bi tamlik* as well as *shukūk muḍārabah*, *muṣḥārah*, *ijārah* and *wakālah*. Furthermore, the judge also seems to recognize that BBA is not a sale but a loan transaction employed only as a mechanism of *ḥilah* (legal artifice) to evade the interest.

In this respect, Azhari (2009) observes that the judge was wrong to state that there were not enough legislations to adjudicate the case, since Malaysian legal statutes and laws provide more than sufficient laws, other than the IBA 1983 and the BAFIA 1989. Furthermore, she also asserted that the judge also was mistaken to rule that if any

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<sup>398</sup> Ibid.

<sup>399</sup> Section 3 (5) (b), the IBA 1983.

<sup>400</sup> The section provides that “when an agreement is discovered to be void, or when a contract becomes void, any person who has received any advantage from the agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he has received it. Section 66, Contract Act 1950.

<sup>401</sup> Azhari, “Islamic Banking,” xciii.

<sup>402</sup> Habhajan Singh, “BBA: Banking Sector braces for Impact Ruling,” The Malaysian Reserve, Sept 11, 2008, accessed on 20 August, <http://islamicfinanceasia.blogspot.de/2008/09/bba-banking-sector-braces-for-impact.html>

of the recognised *madhāhib* stated that an element was not approved by Islam, then the said pronouncement must be valid according to Islam. There is no need for anonymous agreement to state a particular contract is invalid and it is sufficient if only one *madh-hab* states the contract is invalid. Contrary to the judge's conservative stand, many state's legislation had interpreted Islamic legal provision in a more flexible liberal way, where it is understood as "*Islamic law according to any recognised madhhab*". Thus, it is opined that if any of the recognised *madhāhib* accept the contract to be consistent with Sharī'ah, it should be valid according to Islam. Moreover, she also insisted that the interpretation of the judge on *ribā* was mistaken. This is because *ribā* is not merely an increase or an excess in a transaction, but also other factors should be taken into consideration, such as the combination of contracts between loan and sale, which was prohibited by the Prophet or a profit that is not realized through risk could also make the contract is forbidden. In a sale transaction, profit is realized due to the transaction between the seller and buyer, and it should be differentiated from a loan's transaction. Loan contracts in Sharī'ah are voluntary deeds and whatever amount increases from the principal, it is considered *ribā*. It is not an equitable interpretation to regard the profit realized in sales as equivalent to the increase in loan transactions.<sup>403</sup>

Nonetheless, the decision made by the judge Abdul Wahab Patail was overruled by the Appeal Court in 2009 and it was stated that decision was erroneous. The Appeal court found the presided judge on the case had erred to equate profit with *ribā*, misinterpreted a key definition in the Islamic banking rules and had side stepped earlier ruling made by the Supreme Court on the similar cases. The Appeal court ruled that a BBA contract is a sale transaction and not a loan agreement. The profit of BBA is different from interest arising from a loan transaction hence they are diversely different and diametrically opposed transactions.<sup>404</sup> Furthermore, the issues of the inadequacy of the civil court's judges in interpreting Sharī'ah have been lessened by the enactment of section 57 of the CBMA 2009. In that particular subsection, it specifically provides a discretionary power to the SACBNM to interpret and decide Sharī'ah rules pertaining to Islamic commercial law and the decision made by the council is binding to the whole industry. Hence, the judges could not make any arbitrary judgments before consultation

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<sup>403</sup> Azhari, "Islamic Banking," xciii.

<sup>404</sup> Habhajan Singh, "BBA Judgment Erroneous, rules the Court of Appeal," October 19, 2000," The Malaysian Reserve, October 19, 2009, accessed on 20 August, <http://islamicfinanceasia.blogspot.de/2008/09/bba-banking-sector-braces-for-impact.html>.



is made with the council. Furthermore, this provision will on the other hand expose the judges to the element of Sharī'ah in their legal decision.

The decision to obligate the civil court's judges to refer with the SACBNM resolutions is observed to have restricted the independency and power of the judges to use his discretion in deciding of Islamic banking cases. In common law legal system, principally, the judges that adjudicate any cases have been given a discrete authority to decide the cases under his jurisdiction. The restriction of the law will reduce the judges' authority. Furthermore, if the council is given incorrect facts of the cases or has different opinions than the judges, the defendant or plaintiff would not receive fair decision, since the decision made by the council is binding to the court. To solve this issue, it is proposed that the judges must be trained by providing with sufficient knowledge of Sharī'ah and capability to refer to the sources of Sharī'ah in order for them to make their own legal opinion or *ijtihad*. External opinions, such as from the SACBNM can be permitted, but not to the extent that their opinion will be binding to the court, since the trained judges are capable of deciding the cases by their *ijtihad*. In addition, since the current acts and statutes that regulate Islamic banking products do not completely constitute of the substantive Islamic commercial laws, it is proposed that the acts must be amended in order to accommodate the requirements of Sharī'ah principles.

In this regard, the opponents of the judgment observed that the profit of BBA taken by the bank should not be resembled with *ribā*, since the customer and bank entered into two separate and independent contracts through *bay' al-ṭinah*, which is valid under the Sharī'ah law interpreted by SACBNM. The transaction could be done immediately by only exchanging legal document of the contract and the house is considered has exchanged in hand. Therefore, there is no reason to prohibit the transaction, since the contracting parties followed the exact rules of combination of contracts (in combination of contracts' rules, as issued by SACBNM, if the parties would like to combine any contracts, it must be done in a separate transaction).<sup>405</sup> However, from other perspective, although the legal reasoning of the judge was flawed, but the essence and substance of the prohibition of BBA is right and correct. From the whole perspective, the objective of the arrangement is to finance the purchasing of the house, where the bank does not bear any risks, especially ownership risk and equity risk, which should be borne by the seller under the Sharī'ah law. In the actual sense, the bank only acts as a

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<sup>405</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 113.

lender rather than a seller. However, this legal reasoning could be employed in the judgment, i.e. to observe the legal substantive or intention of the contracting parties, since such approach is not recognized under the Malaysian law. Furthermore, there is no legal statute of the Malaysian laws that could support the prohibition of the transaction based on the intention of the contracting parties, which is to circumvent the prohibition against *ribā*. Such prohibition only can be observed as a moral or ethical obligation that should be avoided rather than a legal duty to be observed by the contracting parties.

### 3.7. Sharī'ah Compliant Risk

Another legal challenge in developing Islamic banking products is related to the compliance with Sharī'ah rules, as non-compliance to the Sharī'ah will lead to the exposure of the product to risk. In this regard, risk is considered the life and blood of managing banking business. Islamic banks also may expose to various risks similar to conventional banks. A well-performing Islamic bank is viewed on how good the bank can manage its risk profile and products. Among the key risks exposed by Islamic banks are equity investment risk, liquidity risk, market risk, credit risk, rate of return risk and operational risk, as well as legal risk, which are common to financial and banking institutions. Although other risks are important to be discussed in this respect, this study concentrates to emphasize on risk that related to Sharī'ah compliant process in product development, namely Sharī'ah-compliant risk. It refers to Islamic bank's failure to comply with the Sharī'ah rules and principles determined by the Sharī'ah Board of the IFIs or the authorized body that interpret the rules of Sharī'ah.<sup>406</sup> It is a unique risk, which is not found in conventional risk management's framework. However, the scope of Sharī'ah-compliant risk that is currently practiced emphasizes on the financial, contractual transactions and operational aspects of the products, but not the whole aspect of the Islamic banking system.<sup>407</sup>

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<sup>406</sup> Islamic Financial Services Board (IFSB). "IFSB-1 Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)," (Kuala Lumpur: IFSB, 2005), 26.

<sup>407</sup> Kamal Abdelkarim Hassan and Hassan Ahmed Yusuf, *Investment Risk in Islamic Finance*, accessed on 1 June 2011, <http://www.qfinance.com/contentFiles/QF02/goh8h6ic/14/0/investment-risk-in-islamic-finance.pdf>.

There are many reasons of IBIs are exposed to Sharī'ah-compliant risk, among others, are *ribā*, *gharar*, *maysir*, fraud (*tahgrir*), inequality (*ghubn*), mistake (*ghalaṭ*), duress (*ikrāh*), unfair exploitation (*istighlāl*) and adhesion (*idh'ān*). Other cause includes the non-standardized practices in judicial decision in different jurisdiction regions with respect to certain contracts, such as *tawarrūq*, *bay' al-īnah*, *bay' al-dayn* and *bay' al-wafā* may cause Sharī'ah-compliant risk.<sup>408</sup> They typically occur between two legal systems of jurisdiction at international level whereby some Sharī'ah committees have adopted different standards with other legal jurisdiction and subsequently, it will affect other requirements and systems. For example, different adoptions of Sharī'ah rules sometimes results in differences in financial reporting, auditing, and accounting treatments by Islamic banks. This notion occurs while some Muslim jurists contemplate the term of a *murābahah* or *istiṣnā'* contract to be binding on the buyer and others argue that the buyer has the option to decline even after placing an order and paying the commitment fee. While each practice is supported by different school of Islamic law, the bank's risk is higher in non-binding cases and it may lead to potential litigation problem in case of unsettled transactions.<sup>409</sup> Furthermore, Islamic banks will be exposed to Sharī'ah-compliant risk, if the essential pillars and conditions of contracts are not fulfilled.<sup>410</sup>

Lack of scrutinizing the process of product development and implementation of the product may also cause Islamic banks to be exposed to Sharī'ah-compliant risk. The process of product development normally starts with the presentation of the product to the Sharī'ah board. A representative of product developer's team must present and describe all the features, structures, underlying asset securities, different types of contracts, charges, fees, and other necessary details. The presenter should not hide anything from the knowledge of Sharī'ah board, including the dissident opinions of the contract proposed for the product in order for the board to make judicious decision about the product. The board may suggest some improvement and recommendations based on the presentation given.<sup>411</sup> However, if the product developer conceals some elements from the knowledge of the board, it may cause Sharī'ah-compliant risk. In combination of contracts that involves *muḍārabah* contract, for instance, the element of

<sup>408</sup> Rayner, *the Theory of Contracts in Islamic Law*, 194-258

<sup>409</sup> Iqbal and Mirarkhor, *An Introduction*, 245

<sup>410</sup> Hassan and Yusuf, *Investment Risk in Islamic Finance*, 2-3.

<sup>411</sup> Nonetheless, not all products presented are approved by the board. See Hassan and Yusuf, *Investment Risk in Islamic Finance*, 2-3.

guarantee should not be imposed on the contract, and the provision of guarantee is only allowed when the aspect of negligence or breach of contract is revealed.<sup>412</sup> Similarly, the entrepreneur is also not allowed to promise to purchase back the asset given as capital at an original price, when the venture incurs loss or failure to realize any return or profit. This is because it is tantamount to capital guaranteed, which is prohibited for the contract.<sup>413</sup>

Another factor that may trigger Sharī'ah-compliant risk to Islamic bank is non-compliance with the principles of Islamic accounting system. Islamic accounting is the process of providing appropriate information to stakeholders of IBIs, which enables them to ensure that the bank are continuously operating within the bounds of Sharī'ah and delivering its socioeconomic services.<sup>414</sup> Thus, the IBIs shall keep track of income that is not recognized arising out of Sharī'ah non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of Sharī'ah non-compliance, the IBIs may assess potential profits that could not be recognized as eligible IBIs' profits. All the prohibited earning such as interest, uncertain activities and gambling should be disposed according to the Sharī'ah principles as recommended by the Sharī'ah committee. The best method of the compliance is to observe the ready-made accounting system issued by the AAOIFI, which was prepared and recognized by the Muslim jurists, who consulted the institution.<sup>415</sup>

The negligence of the responsible party to conduct Sharī'ah compliant audit and review also cause Sharī'ah-compliant risk. Both tasks must be diligently managed by IBIs in order to ensure that the product and the operations regularly comply with the Sharī'ah principles, the *fatwā*, policies, and procedures approved by the IBIs' Sharī'ah Board.<sup>416</sup> Sharī'ah audit can be exercised as *ex-ante* (pre-audit) and *ex-post* (post-audit). *Ex ante* means the reviewing, monitoring, and controlling tasks before the product is approved (*i.e.* during the designing of the contracts and agreement). *Ex-post* is to undertake the Sharī'ah compliant process, which requires the Sharī'ah committee

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<sup>412</sup> Zurina Shafii, Supiah Salleh and Syahidawati Shahwan "Management of Sharī'ah Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of Sharī'ah Compliance Audit Framework and Sharī'ah Audit Programme," *Kyoto Bulletin of Islamic Area Studies* 3, no. 2 (March 2010): 3–16.

<sup>413</sup> Muḥammad Taqī Usmani, "Ṣukūk and Their Contemporary Application," *IBF Review* 3, no. 3 (Jan. 2008):1-3.

<sup>414</sup> Mohamed Ibrahim, *Accounting and Auditing for Islamic Financial Institutions*, 2.

<sup>415</sup> Ibid.

<sup>416</sup> Humayon A Dar, and Muftī Talha Ahmad. "Sharī'ah Assurance Process," in *Global Islamic Finance Report 2011*, edited by Humayon A Dar, and Muftī Talha Ahmad (UK: BMB, 2011), 116-123.

members or the Sharī'ah internal officers to check the transactions that took place after the execution of the contracts.<sup>417</sup>

Finally, the factor of the unawareness to other Sharī'ah boards' pronouncement may also cause Sharī'ah-compliant risk, if Islamic banks operate outside of their different legal jurisdiction. Sharī'ah rules may be interpreted differently according to the place, time, and situation as well to the understanding of the Sharī'ah members towards the case presented to them.<sup>418</sup> This can be observed in the case of differing Sharī'ah interpretations between the Middle East and Malaysian jurists with regard to certain contracts applicability in the Islamic banking industry. For example, the IIFAOIC pronounces organized *tawarrūq*, as impermissible because it is considered as a deception to get the additional quick cash from the contract. Hence, the transaction is considered to be containing the element of *ribā*.<sup>419</sup>

The consequence of the non-compliance to Islamic banks is the risk of dissolution of the contract, which will lead to other common risks, such as credit, market, liquidity, and reputational risk.<sup>420</sup> In addition, this will also lead to the most important risk in legal and regulatory framework, namely legal risk. It is a potential loss arising from uncertainty of legal actions and proceeding, such as bankruptcy, foreclosure, lawsuit, and fines.<sup>421</sup> The banks will be exposed to risk especially when the client is default to pay his debt. Islamic banks in this respect will take a legal action of court to order the client to pay the debt. However, in certain cases, the client takes an opportunity to question the legality of legal document and claims that the document is not Sharī'ah compliant and this triggers Sharī'ah compliant and legal risk. For example in the case of *Dato' Haji Nik Mahmud bin Daud versus. Bank Islam Malaysia Berhad*, the plaintiff (Dato' Haji Nik Mahmud) claims that the product offered by the defendant (Bank Is-

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<sup>417</sup> Zulkifli Hasan, "A Survey on Sharī'ah Governance Practices in Malaysia, GCC Countries and the UK: Critical appraisal," *International Journal of Islamic and Middle Eastern Finance and Management* 4, no. 1 (2011), 30 – 51.

<sup>418</sup> See Muḥammad Khālid Mas'ūd, Brinkley Messick and David. S.Powers, "Muftīs, Fatwās and Islamic Legal Interpretation in *Islamic Legal Interpretation Muftīs and Their Fatwas*, edited by Muḥammad Khālid Mas'ūd, Brinkley Messick and David. S.Powers (Cambridge, Massachusetts, London, England: Harvard University Press, 1996), 3-32.

<sup>419</sup> ISRA, "OIC Fiqh Academy Ruled Organised *Tawarrūq* Impermissible in 2009," accessed on 7 Nov 2013, [www.isra.my](http://www.isra.my).

<sup>420</sup> IFSB, "Guiding Principles On Sharī'ah Governance Systems For Institutions Offering Islamic Financial Services," (December 2009): 14

<sup>421</sup> Roger McCormick, "The Management of Legal Risk of Financial Institutions," assessed on 25 May 2013, [http://www.federalreserve.gov/SECRS/2005/August/20050818/OP-1189/OP-1189\\_2\\_1.pdf](http://www.federalreserve.gov/SECRS/2005/August/20050818/OP-1189/OP-1189_2_1.pdf).

lam) is contrary to the principles of Islam or non-Sharī'ah compliance.<sup>422</sup> In this case, the client tries to gain court's order to declare the contract void and null from the inception. As a result, this occasion exposes the bank to legal risks. If the bank is defeated, it will affect the product and the operational aspect of the bank as well as other legal implications such as foreclosure and lawsuit.

In this regard, the IFSB delineates some solutions for Islamic banks to avoid and mitigate Sharī'ah-compliant as well as legal risk. In order to ensure Islamic banks comply with the decision of the Sharī'ah board, the IFSB stated that the banks shall have in place adequate systems and controls, namely Sharī'ah governance system.<sup>423</sup> Furthermore, the banks also must comply at all times with the Sharī'ah rules and principles determined by the relevant body in the jurisdiction in which they operate with respect to their products and activities. This requires the banks to ensure bank's operations, such as deposit acceptance and investment account, financing and investment services are Sharī'ah compliant.<sup>424</sup> In the jurisdiction that does not have a central authority body to observe Sharī'ah matters, the banks shall abide with their own Sharī'ah Board or scholar whose opinions on the Sharī'ah rules and principles are issued.<sup>425</sup> In Malaysia, the compliance of the Sharī'ah rules is undertaken by Sharī'ah committee at institutional level and the SACBNM at national level.

In addition, Islamic banks also must ensure that the contractual documentation conforms to the Sharī'ah rules and principles of pillars and conditions of contracts. These include the formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations. In order to ensure continuous Sharī'ah compliance, Islamic banks must undertake a Sharī'ah compliance review at least annually, performed either by a separate Sharī'ah control department or by persons having the required knowledge and expertise for the purpose. The purpose of this review is to ensure that the nature of the IBIs' financing and equity investment, and the operations of the bank are executed in adherence to the applicable Sharī'ah rules and principles in the *fatwā*, policies and procedures approved by the IBIs' Sharī'ah Board. IBIs also shall keep track of income not recognized arising

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<sup>422</sup> See an analysis of legal disputes made by Apnizan Abdullah and Hakimah Yaakob, "The Trend of Legal Suits involving Islamic Financial Transactions in Malaysia Evidence from the Reported Cases," 1-78 (ISRA Research Paper no.48/2012, International Sharī'ah Research Academy, 2012)

<sup>423</sup> IFSB, "Guiding Principles of Risk Management," 26.

<sup>424</sup> Ibid.

<sup>425</sup> Ibid., 27.

out of Sharī'ah non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of Sharī'ah non-compliance, the IBIs may assess potential profits that cannot be recognized as eligible IBIs' profits.<sup>426</sup>

### 3.8. Legal Documentation of Islamic Banking Products

In order to mitigate the exposure of Islamic banking products to various risks, legal documentation is one of the aspects that must be heavily concerned by product developers in Islamic banks. Sharī'ah-compliant legal documentation reflects the genuine Sharī'ah requirements that aims to ensure all the contracting parties have fair transactions. This is also may avoid the accusations that Islamic transactions are similar to conventional ones. Legal documentation is an official and legitimate agreement that assigns the responsibility, rights, and obligations of the terms, conditions, and parameters delineated between the contracting parties that is normally prepared in a set of papers. It is an important record to establish the determination and validity of the contracting parties, as well as to address specific necessities or requirements of the counterparties. The drafter of the document, either Islamic bank or customer, in this case the bank must specify, in detail, all the requirements needed into the legal documentation to clarify the rights and liabilities of each party in order to avoid any legal disputes in the case of default or breach of contract in the future. When the terms and conditions in the contract are agreed upon, then all parties involved must adhere to the terms and conditions within the contract.<sup>427</sup>

As compared to conventional legal documentation, which is typically based on loan contract, Islamic banking facility documentation is obviously different from the former, since it is drafted in accordance to Sharī'ah principles, which engage many contracts in a single agreement. The contracts have specific requirements and legal consequences (*muqtaḍā al-'aqd*) which have to be observed, such as the specific information of the subject matter, the rights of the contracting parties, and the price. Legal documentation is also one of the methods to avoid and reduce legal and Sharī'ah-

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<sup>426</sup> IFSB, "Guiding Principles of Risk Management," 27.

<sup>427</sup> Chaired Islamic Financial Professional Part 1 (C1FP), "Understanding Sharī'ah Requirements in Legal Documentation" in *Sharī'ah Aspects in Business and Finance* (Kuala Lumpur: INCEIF, 2010), 1-17; Mohammad Ali El-Gari, "Documentation of Islamic banking products," accessed on 30 October 2013, <http://www.elgari.com/english/wp-content/uploads/downloads/2011/08/Sukuk.pdf>.

compliant risk, because when a product is being challenged in the court, the judge will rely heavily on the terms, conditions and clauses in the documents contracted by both parties.<sup>428</sup>

Since Islamic banking products are new to the industry, most agreements, clauses and terms are heavily drawn from the conceptual documents of conventional products. Hence, this has become criticisms, since some of the clauses applied are similar to conventional legal documentation. These include condition precedence, cross default, pre-payment, consolidation and set-off right to recall the facility force majeure and penalty or compensation clauses.<sup>429</sup> Nonetheless, it has been argued that some of these clauses are standard in the financial market, neutral and not contradicting to the Sharī'ah requirements, and thus can be retained in the documents.

Despite having shunned all the loan and interest payment, Islamic legal documentation also must avoid all clauses that are prohibited by the Sharī'ah, either in the form of structure or legal rights or liabilities arising from the structure. The drafter of the legal documentation must be aware the other forms of prohibition such as the prohibition of combining loan and sale terms in a single contract and contracts that are opposite in terms of its nature and legal consequences. This is because these contracts cannot be combined in order to prevent a combination that would lead to the circumvention of prohibition of *ribā* and uncertainty transaction. Furthermore, they cannot be simply combined, since each contract has its legal consequences, which require fulfillment. For example, in sale and leaseback structure, sale must be contracted first before it is followed with lease contract. The method of sequence in that particular arrangement is essential in order to avoid that it fall under the interpretation of “two sales in one sale,” which is prohibited by the Prophet. In this respect, the owner of the asset must transfer his possession in full legal ownership, without imposing any encumbrances to the asset that may hinder the new owner from utilizing or benefiting from the asset. After the conclusion, then the new owner is allowed to lease back to the original seller.<sup>430</sup>

As a financier, Islamic bank is neither a lender nor borrower (except if it is specifically stated that the bank gives a loan to the borrower), but the bank attempts to fa-

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<sup>428</sup> Ibid., 6

<sup>429</sup> See the discussion of the clauses in CIFP, “Understanding Sharī'ah Requirements in Legal Documentation,” 13-17.

<sup>430</sup> Ibid., 1-2



cilitate the needs and wants of the customers by structuring the product based on various contracts. Therefore, if the contract is based on lease agreement (*ijārah*), therefore conventional terms like loan and interest payment in the form of the repayment of principal plus the payment of a premium on loan are invalid and should not be included in the contract. *Ijārah* contract is a sale of usufruct in which there is no involvement of any interest payment for the rental made by the lessee to the lessor. However, it is contended that the rental charged by the lessor can be based on the interest-benchmark and this is permitted by the Sharī‘ah scholars in order to price the rental competitively with the conventional lease. Nonetheless, the presence of the terms in legal documentation of *ijārah* may dilute the meaning of the contract from the Sharī‘ah perspective.<sup>431</sup>

In addition to the transfer of ownership, the issue of the contracting parties who are involved in the transaction is also equally important. In a simple Islamic financial transaction, the contracting parties engaged must be clearly identified. However, in some of the Islamic banking structures, the contracting parties are involved in fictitious transaction, where they synthetically organize the transaction in order to make it valid from the Sharī‘ah perspective. In order to avoid this, for example, the AAOIFI stipulates that in the contract of the parallel *istiṣnā’* or parallel *salam* or *tawarrūq* structure, the customer and the bank must be of different entities in order to avoid the contract similar to *bay‘ al-‘īnah*. In parallel *istiṣnā’*, the contracting parties involved in the contract must be separate identities. The first contract of *istiṣnā’* is entered by the bank, as the financier and provider of financing to its customer as the purchaser. Subsequently, the bank, acting as the purchaser, enters into another contract of *istiṣnā’* with the supplier that will manufacture the item ordered by the customer. In this respect, it is not allowed by the AAOIFI for the bank to act simultaneously, as the seller and purchaser at the same time and thus the first and second contract must be independent and separate in order to avoid a similar structure to *bay‘ al-‘īnah*, which was prohibited by the AAOIFI.<sup>432</sup>

Another issue in legal documentation of Islamic banking products is the use of *wa‘d*. *Wa‘d* is a mere promise undertaken by a unilateral party to carry an obligation on a particular subject matter or task that will be performed in the future.<sup>433</sup> It is regarded

<sup>431</sup> CIFP, “Understanding Sharī‘ah Requirements,” 6

<sup>432</sup> Ibid., 14-15.

<sup>433</sup> Nurdianawati Irwani Abdullah, “Status and Implications of Promise (*Wad*) in Contemporary Islamic Banking,” *Humanomics* 26, no. 2 (2010): 84 – 98; Thomas *et. al.*, *Structuring Islamic Finance*, 24.

as juridical act to support the future transaction. It is not regarded as contract, since contract in the Sharī'ah is bilateral contractual arrangement. A unilateral promise to carry out an obligation or duty cannot be regarded as a contract since; it does not involve two parties.<sup>434</sup> It is a juridical act or mere promise and can be applied to buying and selling something in the future, without necessarily abiding to the rules of sales contract, which takes spot delivery of both counter-values (e.g. sales contract) or at least one of the counter-values (e.g. *salam* and *istiṣnā'*). However, the issue of *wa'd* triggers Sharī'ah issues, as it is used to sell something, which is not in the possession of the seller and to guarantee the capital of *muḍārabah* or *musaharakah* contract that was prohibited in the Sharī'ah. The former case happens in the contract of *bay' al-murābahah lil-āmr bi-al-shirā'* (murābahah to a purchase orderer). A customer approaches the bank and requests the bank to purchase an asset from a supplier. The bank then requires the customer to give a purchase undertaking to buy the asset from the financier. Typically, the contract of MPO is already undertaken before the asset is owned by the bank, thus this event causes the issue of selling something, which is not under the possession of the bank yet.<sup>435</sup>

Another challenge in preparing legal documentation of Islamic banking products is the issue of ownership transfer. In normal sale transaction, the ownership of the asset sold is transferred immediately after the contract is concluded. For example in BBA transaction of a house under construction, the seller is supposed to have ownership over the house that he means to sell. However, under the Property Sale Agreement (PSA), which is signed by the customer and developer after the buyer pays 10% of instalment, he is deemed to have the ownership of the asset, although he has not fully paid the purchase price. This is also recognized by Malaysian Sharī'ah scholars as the fact that the buyer is the "beneficial" owner of the house purchased.<sup>436</sup> Hence, the customer is entitled to apply for a financing from any Islamic banks by selling the house to

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<sup>434</sup> This definition is adopted the position of the Mejlle, since in the Sharī'ah there is a category of contract that takes legal effect, although only one party expresses his determination to conclude the contract without any acceptance by the other party, namely gratuitous contracts, such as *ṣadāqah* (gift), *waqf* (endowment), *hadiyah* (gift) and etc. Article 1-3, The Mejlle. "Book I: Sale," translated by C. A. Hooper, *Arab Law Quarterly* 1, no. 5 (Nov., 1986): 525-556.

<sup>435</sup> Rafic Yunus al-Masri, "The Binding Unilateral Promise (*Wa'd*) in Islamic Banking Operations: Is it Permissible for a Unilateral Promise (*wa'd*) to be Binding as an Alternative to a Proscribed Contract." *Journal King Abdul Aziz University: Islamic Economics* 15 (2002): 29-33; See also Deutsche Bank White Paper (DBWP) (2007), "Pioneering Innovative Shari'a Compliant Solution," accessed on 13 September 2013, [http://www.db.com/presse/en/download/White\\_Paper.pdf](http://www.db.com/presse/en/download/White_Paper.pdf)

<sup>436</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 6.

the bank with cash price and buy it back with deferred payment in order to settle the full process of the financing. However, this practice has been criticized, when it is sold to the bank, the process of transfer of ownership of the house does not really occur between by the customer and the bank. This is proven, when the house, bought by the customer and sold to the bank and re-bought by the customer again, is abandoned, the responsible party for the house is only the customer and developer, whereas the bank escapes bearing the risk. In fact, the bank is also a responsible party and ought to assume part of the abandoned risk, since it also sold something, which was not completed yet, when the bank dealt with the customer. What is of concern to the bank is only to ensure that the customer fully pays the whole sum of the debt owed to the bank, since it only acts as a financier or, in other words as a borrower. In this respect, this is a challenge and a dilemma to the drafter of the document to prepare an agreement's document that is Sharī'ah compliant and at the same time takes into consideration the bank's requirements.<sup>437</sup>

It is pertinent to examine the processes undertaken by Islamic banks in preparing Islamic legal documentation in order to comprehend the overall issue. In this case, the present study has chosen a product, namely *al-ijārah thuma al-bay'* (AITAB), since it is a complex product that involves combination of two contracts. It is relevant to study the product since it provides an overall picture on how Islamic banking document is prepared. AITAB is a financial transaction structured by combining two contracts, namely *ijārah* and *bay'*. Normally, this contract is employed to finance the acquisition of vehicles and moveable and immovable properties. The purpose of the contract is to lease out the lessor's asset to the lessee, and at the end of the lease period, the lessor will sell the asset to the lessee through a sale contract (*bay'*). This combination of contracts is equivalent to conventional banking product, namely hire-purchase or financial lease that allows a lessee the option to acquire the asset at the end of lease period. It is also known as *al-ijārah muntahiyah bi tamlīk* or *al-ijārah wa iqtinā'*, which means lease that leads to acquisition. Both contracts are quite different from the former, where in the latter contracts; the asset will be transferred through gift (*hibah*), whereas under the former, the transfer of ownership is taken through sale contract. Under such particular contract, the tenant pays rental every month under lease contract, and a sum amount of the rental goes towards the portion of buying the lease asset. The tenant actually

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<sup>437</sup> Dusuki and Abdullah, *Fundamentals of Islamic Banking*, 217-222.

pays gradually the price of the asset with the result that at the end of lease period, the lessor promises to sell or grant the asset to the lessee.<sup>438</sup>

There are two required sets of agreements, namely *ijārah* and *bay'* in drafting the legal document of AITAB, such as follows. Firstly, the lessee (the customer) and the lessor (the bank) will conclude a novation agreement, which refers to the agreement made between the lessee and lessor that after the client buys an asset from the vendor/dealer, the customer agrees to transfer the rights, obligations and ownership of the asset to the financier/lessor. The result of the novation agreement is that the lessor i.e. the bank will become a new owner of the asset and the lessor is allowed to lease the asset to the lessee (the customer). Secondly, the lessor will propose a letter of offer that addresses the terms and conditions of the AITAB facility with the details of the financing offered. Thirdly, both parties sign an AITAB agreement. It is the core component in the facility arrangement that refers to the customer's agreement to rent the asset from the lessor in accordance with specific terms and conditions. Fourth element is sale or *hibah* agreement that indicates that at the end of lease period, the ownership of the asset will be transferred to the customer at a price that is mutually agreed upon by both parties. Fifth aspect is invoices, where every invoice of the asset must be billed to the financier, as he is the legal owner of the asset before it is fully transferred to the lessee. Sixth element is asset receipt validation, where the customer confirms that the supplier/vendor has delivered the asset to him. This is because the financier/lessor does not typically see the asset; after it was purchased by the customer since the interest of the financier is financing the asset intended, which must be owned by the customer. Seventh element is to certify the acceptance and satisfaction through which the customer confirms that the financier is the new owner, the asset leased has complied with the requisite specifications and is good in condition. Further element is guarantee and indemnity or letter of undertaking, which refers to a written confirmation by the guarantor that he will guarantee all sums of rental payment, which may be due by the customer. Finally, *takāful* cover note that refers to the asset as being fully covered by the *takāful* policy in the joint names of the financier and the customer.<sup>439</sup>

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<sup>438</sup> Aida Othman Megat Hizaini Hassan Mohd Sofiyuddin Ahmad Tabrani Mohd Hariz Daud Iqbal Jusoh, *An Introduction to Islamic and Conventional Corporate Finance* (Kuala Lumpur: Sweet and Maxwell, 2013), 78; see also Al-Bashir Muḥammad al.Amine, *Global Shukūk and Islamic Securitization Market: Financial Engineering and Product Innovation* (Leiden: Brill, 2012), 120.

<sup>439</sup> Ibid., 78-80.

From the above legal documentation's process of AITAB, it is observed that some of the steps prepared in the legal document of AITAB are undertaken as a cosmetic arrangement to satisfy the requirements of Sharī'ah. For instance, the creation of novation agreement is invalid from the perspective of Sharī'ah, because when the customer has bought the asset from the seller, he is considered a real owner of the asset. It is an ambiguous process to the extent that the novation agreement is enforceable, whether it takes effects similar to the real owner or partial ownership. It is seen that it is similar to temporary ownership, where the bank does not bear the whole responsibility as the real owner, such as it does not bear the cost of maintenance of the asset and *takāful* coverage. The real objective of the novation agreement is to satisfy the Sharī'ah requirements that an asset must be owned by the seller or lessor before he may sell or lease the asset. If it is a partial ownership, then the transaction is void from the Sharī'ah perspective, since it is not recognized in the Sharī'ah.<sup>440</sup>

To remedy the flaw in the process of preparing the legal documentation, it is recommended that the customer identifies first the intended asset to be purchased and then negotiates with the bank to finance the purchasing of the asset. The bank then purchases the asset and leases the asset to the customer under the concept of AITAB. When the bank purchases the asset, it automatically owns the asset and bears the whole risk, including ownership risk. Hence, this structure complies with the Sharī'ah requirement.<sup>441</sup>

### 3.9. Conclusion

The above discussion presents our case of the legal and regulatory challenges faced in structuring Islamic banking products and services. It is observed that the main impediment of developing genuine Islamic banking products in Malaysia is the legal and regulatory framework, which regulate the process and implementation of product development is not Sharī'ah law. In this regard, the banks have to comply with both re-

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<sup>440</sup> Nurdianawati Irwani Abdullah and Seif I. Tag El-Din, "Issues of Implementing Islamic Hire Purchase in Dual Banking Systems: Malaysia's Experience," *Thunderbird International Business Review*, 49 no. 2 (March–April 2007): 225–249.

<sup>441</sup> Nurdianawati Irwani Abdullah and Asyraf Wajdi Dusuki, "Customers' Perceptions of Islamic Hire-Purchase Facility in Malaysia: An Empirical Analysis," *IIUM Journal of Economics and Management* 14, no. 2 (2006): 177–204; Abdullah and El-Din, "Issues of Implementing Islamic Hire Purchase, 225–249.

quirements of national and Sharī'ah laws in developing Islamic banking products. Although the Malaysian Government has developed a good legal and regulatory framework to cope with the development and progress of Islamic finance in Malaysia, however that framework is still insufficient to ensure the Islamicity of the products, which the present study has discussed in the chapter 1. This is shown especially in the IFSA (2013), which only acts as the supervisory and monitoring law of Islamic banking products. Furthermore, the power given by the CBMA (2009) to SACBNM in determining the legal ruling on Islamic financial services and the court or arbitrator shall take into consideration of any published rulings of the SAC for its ruling before deciding any cases, is also unable to ensure the Islamicity of the products. This is due to some of the legal provisions that regulate Islamic banking products are still inconsistent with the Sharī'ah law. This is aggravated with the legal judiciary system in which the court that should adjudicate the Islamic banking's cases is not Sharī'ah court, but civil court. Furthermore, the judges that adjudicate the cases are also incompetent with the Sharī'ah rules, which results the cases decided are inconsistent with the Sharī'ah. Therefore, it is a time for the government to compile Sharī'ah rules in the form of *fatāwā* issued by SACBNM in legal codes so that judges in civil courts can employ these codes in their judgement.

## CHAPTER 4: LEGAL ARTIFICES IN ISLAMIC BANKING

### 4.1. Introduction

*“The invocation of ḥiyal raises an important consideration. At what point do legal stratagems become illegitimate? When does splitting hairs render an entire activity suspect?”<sup>442</sup> (Maurer, 2005)*

The employment of *ḥiyal* in Islamic banking products development has become a critical issue since it has been regarded as a tool to Islamize conventional products and to evade the prohibition of *ribā*. Therefore, this chapter focuses on clarifying *ḥiyal* from Sharī‘ah perspective and its application in Islamic banking. This chapter is structured as follows: firstly, it discusses the definition of *ḥiyal*, scholarly debates on *ḥiyal*, permissible and prohibited *ḥiyal*, intention and *ḥiyal*, identifying *ḥiyal* in Islamic commercial law and parameter of *fiqh*. For further understanding of its application in Islamic banking, it also examines two instruments that are considered as *ḥiyal*, namely *bay‘ al-‘īnah* and *tawarrūq*.

### 4.2. Defining *Ḥiyal* in Sharī‘ah

*Ḥiyal* (plural of *ḥilah*) in an Arabic term or legal artifices in English translation literally mean artifice, trick, device, expedient, devices, ruses, subtle, the means of evading a thing, or affecting an object.<sup>443</sup> According to Ibn Manẓūr (d.1312, *ḥiyal* are resourcefulness, sharpness of intellect and skill in management of affairs.<sup>444</sup> In this respect, *ḥiyal* appears to have both positive and negative connotations. Generally, the employment of *ḥiyal* in the public sphere is to be negatively perceived, but in certain circumstances, the term is also positively used to symbolize wisdom, acumen, and sagacity. The root word of *ḥiyal* is derived from *ḥawl*, which means transformation (*taḥawwul*) from one position to another, possibly through some finely executed design that helps conceal the reality. It could also be a derivation of the root term *hawl*, which

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<sup>442</sup> Bill Maurer, *Mutual Life: Islamic Banking, Alternative Currencies Lateral Reason* (Oxfordshire: Princeton University Press, 2005), 73.

<sup>443</sup> Schacht, “*ḥiyal*,” 510.

<sup>444</sup> Muḥammad ibn Mukarram Ibn Manẓūr, *Lisān al-‘Arab* (Jordan: Markaz al-Turūth, 1999), vol. 11, 186.

means capability (*quwwah*), which is applied to denote the strategy of attaining or acquiring some objective, usually in a covert manner.<sup>445</sup>

Technically, there are numerous descriptions given by the Muslim scholars on *hiyal*, particularly by the Ḥanafīs. Al-Khaṣṣāf (d.874/875) defines the term as a method used by a person as a solution to transform from impermissible act (*ḥarām*) into something lawful (*ḥalāl*).<sup>446</sup> Al-Shaybānī (d. 804/805.) explains *hiyal* as a method to escape from what is forbidden and to enter what is permissible (*ḥalāl*) or to seek the lawful act.<sup>447</sup> Al-Sarakhsī (d.1090) regards that *hiyal* are legal artifices used to revoke the rights of others or enter into doubtful (*shubḥah*) matters or to conceal faults. This act is categorized as reprehensible (*makrūh*). However, if *hiyal* are used to relieve someone from something impermissible (*ḥarām*) or to convey something from impermissible to permissible (*ḥalāl*), then they are virtuous.<sup>448</sup> He states that it is allowed for a jurist consult (*muftī*) to answer inquiries asked in a way of trick that could achieve the purpose of Sharī'ah when there was no clear answer for it. The purpose of *hiyal* is to avoid any illegal action, therefore, this legal act shall not be considered as disapproval act, and it does not imply as to teach tricks.<sup>449</sup> Meanwhile, Ibn Nujaym (d.1563) refers *hiyal* to the wisdom in administrating something by using a reasonable judgment to find a solution to achieve a specific purpose.<sup>450</sup>

On the other hand, there was unclear definition given by the Shāfi'īs' school to *hiyal*, as compared to the Ḥanafīs. Al-Qazwīnī (1048/49), for example did not mention any definition in his treatise; *Fiqh al-Ḥiyal*.<sup>451</sup> Ibn Hajar al-Haytamy (d.1503) denotes *hiyal* is doing something to revoke the rights of others after they were promulgated,

<sup>445</sup> Wizārat al-Awqāf wa al-Shu'ūn al-Islāmīyah, *al-Mawsū'ah al-Fiqhīyah* (Dawlat al-Kuwayt, Wizārah al-Awqāf wa al-Shu'ūn al-Islāmīyah), 1983, vol. 18, 328; Muḥammad Abdurrahman Sadique, "Early Juristic Approaches to the Application of Ḥiyal," *International Islamic University Malaysia Law Journal* 16, no. 2 (2008):157-180.

<sup>446</sup> Aḥmad ibn 'Umar al-Khaṣṣāf, *Kitāb al-Khaṣṣāf fī al-Ḥiyal* (al-Qāhirah: Maktabah al-Qāhirah, 1314H), 4, 20.

<sup>447</sup> Muḥammad ibn al-Ḥasan al-Shaybānī, *Kitāb al-Hujjah ahl al-Madīnah* (Hayderabad: Maktabah Dāirat al-Ma'arif al-Sharqīyah, 1385/1963), vol.2, 585, 586-587, as cited in Satoe Horii, "Reconsideration of Legal Devices (Ḥiyal) in Islamic Jurisprudence: The Ḥanafīs and their Exits (*Makhārij*)," *Islamic Law and Society* 9, no. 3 (2002), 318.

<sup>448</sup> See Abū Bakr Muḥammad Ibn Abū Sahl Aḥmad Shams al-Dīn al-Sarakhsī, *al-Mabsūṭ*. Bayrūt: Dār al-Fikr, 2000, vol. 30, 373; see also al-Syakh Nazzām, *al-Fatāwā al-Ālamgīrīyah fī al-Furū' al-Ḥanafīyah* (Al-Maktabah al-Shamilah 3<sup>rd</sup> edition, n.d.), vol. 6, 390.

<sup>449</sup> al-Sarakhsī, *al-Mabsūṭ*, vol. 30, 373 and vol. 14, 6; see other definition by al-Syakh Nazzām (*et. al*), *al-Fatāwā al-Ālamgīrīyah*, vol. 6, 390.

<sup>450</sup> Zayn al-'Ābidīn Ibn Ibrāhīm Ibn Nujaym, *al-Ashbāh wa al-Nazā'ir* (Dimashq: Dār al-Fikr, 1983), 477.

<sup>451</sup> Abū Hatim Maḥmūd ibn al-Ḥasan al-Qazwīnī, *Kitāb al-Ḥiyal fī al-Fiqh*, edited by Joseph Schacht *Das Kitāb al-ḥiyāl fīl-fiqh* (Hannover: Orient-Buchhandlung Heinz Lafaire, 1924)



which is not considered as a complete definition of *hiyal*.<sup>452</sup> Although the Shāfi'īs did not state a formal definition in their treatises, they nevertheless, are still considered, as a group that supports *hiyal* (*ahl hiyal*), as there are many attestations to show that they agree over some practices of *hiyal*, particularly in the case of *bay' al-ṭinah*.<sup>453</sup>

The Mālikīs and Hanbalīs' juris have thoroughly defined the definition of *hiyal* in their treatises with negative connotations. For example, al-Shāṭibī (d. 1388) relates *hiyal* as doing things that are permitted in original form of legal ruling; however *hiyal* are prohibited when they are employed to alter the permissible legal ruling to become forbidden or *vice-versa*. Accordingly, such action will damage the fundamental legal methods of legal deduction (*qawā'id al-Sharī'ah*).<sup>454</sup> Meanwhile, Ibn Qudāmah of Hanbalīs (d. 1223) regards *hiyal* as disclosing a lawful means to achieve an unlawful objective, for which such an act is regarded as a deceitful way to legitimize something that was forbidden or plunging something that was obligatory or denying the rights of others.<sup>455</sup> Ibn Taymīyah (d. 1328) explains that *hiyal* are a concealed method that requires wisdom and aptitude to achieve a particular goal. If the goal is virtuous, then it is considered as a permissible and a legal *hilah*, but if the purpose is of the opposite, then it is an illegal *hilah*.<sup>456</sup> It appears that he does not completely reject *hiyal*, but, in other parts of his book, he refers *hiyal* as an intention to rescind the mandatory (*wajib*) or to make impermissible into permissible by doing additional and unnecessary action, in order to make it valid in Sharī'ah, which seems that he opposed to the practice of *hiyal*.<sup>457</sup> Ibn Qayyim (d. 1350) describes *hiyal* are the ingenious management of aspects regarding a legal dealing in an unintended manner.<sup>458</sup> Meanwhile, contemporary scholars, such as Ibn 'Ashūr (2006) defines *hiyal* as performing illegal act that was prohibited in

<sup>452</sup> Aḥmad ibn Muḥammad ibn 'Alī ibn Ḥajar al-Haytāmī, *al-Fatāwā al-Fiqhīyyah al-Kubrā* (Bayrūt: Dār al-Fikr, n.d.), vol. 3, 14.

<sup>453</sup> Muḥyī al-Dīn Abū Zakariyyā Ibn Sharaf al-Nawāwī, *al-Minhāj fī Sharḥ Ṣaḥīḥ Muslim bin al-Hajjaj* (Bayrūt: Dār Ma'rifah, 1425H/2004), vol. 11, 21.

<sup>454</sup> Ibrāhīm Ibn Mūsā al-Shāṭibī, *al-Muwāfaqāt fī 'Uṣūl al-Sharī'ah* (al-Qāhirah: al-Maktabah al-Tijārah al-Kubrā, n.d), vol.4, 558; Mohamed Fairouz Abdul Kadir, Marjan Muḥammad, Ashraf Md. Hashim, Said Bouheraoua, Lokmanulhakim Hussain and Imran Iqbal, "Parameter Ḥiyal dalam Kewangan Islam" (Parameters of *Ḥiyal in Islamic Finance*)," (paper presented at Muzakarah Cendekiawan Syariah Nusantara 2010, Putrajaya International Convention Center, Putrajaya, 10-11 November 2010)

<sup>455</sup> Abī Muḥammad 'Abd Allāh ibn Aḥmad ibn Muḥammad Ibn Qudāmah al-Maqdīsī, *al-Mughnī* (Riyāḍ: Maktabah 'Ālam al-Kutub, 1997), vol.6, 116.

<sup>456</sup> Taqī al-Dīn Abū al-'Abbās Aḥmad ibn Ḥalīm ibn 'Abd al-Salam ibn 'Abd Allāh Ibn Taymīyah, *al-Fatāwā al-Kubrā* (Bayrūt: Dār al-Kutub al-'Ilmiyah, 1987), vol. 6, 106.

<sup>457</sup> Ibid. vol. 6, 17.

<sup>458</sup> Ibn Qayyim al-Jawzīyyah, *I'lām al-Muwaqqi'īn*, vol. 3, 188.

the Sharī'ah in a permissible way or executing unlawful act through allowed means in order to achieve a specific purpose.<sup>459</sup>

From the proponents' perspective, *hiyal* are the solutions to exit from the ordinary way of doing things. This is done either to circumvent the legal means that aim to escape from the rigidity of the law or to evade observing the rules of Sharī'ah due to the hardships or difficulties, without destroying the objectives of Sharī'ah. Such solutions are employed whenever someone has no choice or alternative but, to act against the provisions of Sharī'ah rules and to arrive at the desired result while actually conforming to the letter of the law. Mostly, *hiyal* are not based on the texts, but creative thinking or subtle management proposed by Muslim jurists to avoid the rules.<sup>460</sup> On the other hand, from the opponents' perspective, they relate *hiyal* to negative action, which is purposely done by the actor to circumvent the rules of Sharī'ah. However, the different of definitions opinions about *hiyal* among jurists have raised scholarly debates on what is permissible and prohibited *hiyal*.

### 4.3. Scholarly Debates on *Hiyal*

Muslim jurists have different opinions over the position of *hiyal* in Sharī'ah. The schools that support *hiyal* are mainly the Ḥanafīs and Shāfi'īs, as they have taken a liberal attitude and flexible approach over *hiyal* since for them the validity of a contract is based on the contractual performance, not the substantive content of the contract. If the contract has fulfilled the entire requirements, without observing the real intention of the contracting parties, it is considered valid contract. According to Abū Ḥanīfah, as quoted by al-Shātibī (d.1388), "the explicit intention to repeal the provisions of Sharī'ah is forbidden, but to revoke the provisions implicitly, the contract is not prohibited".<sup>461</sup> Al-Shaybānī (d. 804/805) has said, "If a Muslim does a *hilah* with the intention of eliminating a forbidden matter, or achieving a permissible matter, then there is nothing wrong or no harm. However, if he uses it with the aims of invalidating the right of

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<sup>459</sup> Ibn 'Ashūr, *Treatise on Maqāṣid al-Sharī'ah*, 187; Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law*, 45.

<sup>460</sup> Muḥammad Tahir Mansoori, "Use of *Hiyal* in Islamic Finance and its Sharī'ah Legitimacy," *Journal of Islamic Business and Management* 1, no. 1 (2011):69-92.

<sup>461</sup> Although al-Shātibī is a Mālikī's jurist, he also has supported that not all *hiyal* are impermissible. He emphasized on the role of intention that plays as to whether that *hiyal* are permissible or not. See al-Shātibī, *al-Muwāfaqāt*, vol. 4, 202.

someone, or allowing something corrupt or incorporating something with *hiyal* or *shubhah* (obscurity) upon the right, then it is reprehensible. This practice is closest to the prohibition (*makrūh al-tahrim*)”.<sup>462</sup> Al- Khaṣṣāf (d. 874/875) asserts that, “There is nothing wrong with someone who uses *hiyal*, where the purpose of the action is to eliminate actions from sin or illegal and to exit from prohibitions. However, it is reprehensible (*makrūh*), if someone employs *hiyal* to other person in order to usurp the rights of the person, deceive people, or enter into obscurity (*shubhah*) matter.”<sup>463</sup> Ibn ‘Ābidīn (d. 1836) offers as suggestion for a person, who wishes to give an extension of time to his debtor in lieu of some increase for debt, the lender may purchase some commodity against the amount of debt from the debtor and then sells the same commodity to him on credit with a higher price. However, this approach, as asserted by Mansoori (2011), is unacceptable, as it clearly violates the purpose of law.<sup>464</sup>

Al-Sarakhsī (d.1090) contends that the overwhelming majority of scholars concur on this exception for some *hiyal*, which he refers to as lacking discernments from the Qur’ān and the Sunnah. *Hiyal*, that are approved in the school are practiced in order to avoid the prohibitions or secure what is lawful or to release from the hardships caused by negligence of the perpetrator. However, *hiyal* that are reprehensible (*makrūh*) are those adopted to eliminate or eradicate a person’s right, to disguise a wrongdoing or to create doubts in a right.<sup>465</sup> The same legal provision is also recapped clearly in *al-Fatāwā al-‘Ālamgīrīyah*, which is regarded as the staunchest writing on the genre of *hiyal*, as it provides a specific chapter for it.<sup>466</sup>

Al- Khaṣṣāf (d. 874/875) opines that the legitimacy of *hiyal* is based on the intention of the contracting parties. However, he views that immoral intention is insufficient to render a contract as invalid, but only makes it reprehensible. The contract is still legally recognized.<sup>467</sup> He then substantiates his argument by saying that this ‘opinion’ is opposed to the Qur’ānic general principles of recognizing contracts founded on a clear proof-texts basis. He expresses that the intention does not prevent the effects of

<sup>462</sup> Wizārat al-Awqāf wa al-Shu’ūn al-Islāmīyah, *al-Mawsū‘ah al-Fiqhīyah*, vol.38, 373; Muḥammad Ibn Ḥassan al-Shaybānī, *al-Makhārīj fī al-Ḥiyāl* (al-Qāhirah: Maktabah al-Thafaqah al-Dīniyyah, 1419H/1999), 94.

<sup>463</sup> Al- Khaṣṣāf, *Kitāb al-Ḥiyāl*, 4.

<sup>464</sup> Muḥammad Amīn ibn ‘Umar Ibn ‘Ābidīn, *al-‘Uqūd al-Durrīyah fī Tanqīh al-Fatāwā al-Ḥāmīdīyah* (Al-Qāhirah: al-Maktabah al-Maymaniyyah, n.d) vol. 2, 245; see also Mansoori, “Use of *Hiyal* in Islamic Finance, 74.

<sup>465</sup> Al-Sarakhsī, *al-Mabsūt*, vol. 30, 210.

<sup>466</sup> Al-Syakh Nazzām (*et.al.*), *al-Fatāwā al-‘Ālamgīrīyah*, vol. 6, 443.

<sup>467</sup> Al- Khaṣṣāf, *Kitāb al-Ḥiyāl*, 7.

the contract concluded although the intention itself is prohibited. He goes on to refer to a verse that a husband is prohibited from harming his wife by retaining her and not granting her a divorce. He then quotes a saying of Ibn Masqūr, a successor jurist that the verse has a background, of a husband who divorce his wife and when her waiting period is about to terminate, he takes her back. The husband did not intend to remain with her but the act of taking her back was solely a matter of vindictiveness against his wife.<sup>468</sup>

As mentioned above, the Shāfi'īs' jurists also agreed on some practices of *hiyal* that are used in evading *ribā*, *waqf*, *waṣīyah* (will), and pre-emption and so on.<sup>469</sup> For example, al-Nawāwī (d. 1277) commented on the issue of *bay' al-ṭinah*, "It is not prohibited. It is a *ḥilah* used by someone, which reaches similar meaning to *ribā*, for example, someone (the borrower) wishes to lend something to someone in exchange one hundreds with two hundreds *dirhāms*, the *ḥilah* is he sells a garment with two hundreds *dirhāms* and buys back with one hundreds *dirhāms*".<sup>470</sup> This is permissible in the Shāfi'īs' school, since the transaction is executed in the legalized form of sale transaction.

The proponents of *hiyal* provide their evidences that *hiyal* are actually derived from the teachings of the Qur'ān and *aḥādīth*.<sup>471</sup> They normally quote the popular Qur'ānic proof to justify the use of *hiyal*, among other it was quoted from the Sūrah Ṣād: 44, that Allāh said, "And (We said again to him): Take your hand a little grass, and strike therewith (your wife) with her and break not your oath. Indeed, we found the Prophet Ayūb was a patient, how excellent a servant! Verily he was ever oft-returning in repentance (to Us)!".<sup>472</sup> In this respect, Prophet Ayūb scolded his wife and vowed (took an oath) to beat her with 100 lashes if God heals him from his illness. When he had recovered, he was not willing to beat his wife then; God had given him an idea (a *ḥilah*) to use a bundle of twigs containing 100 of sticks and hit his wife with a stroke.

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<sup>468</sup> Ibid. 7.

<sup>469</sup> Rosman, "*Hiyal wa Makhārij*", 104.

<sup>470</sup> Muḥyī al-Dīn Abū Zakariyyā Ibn Sharaf al-Nawāwī, *al-Minhāj fī Sharḥ Ṣaḥīḥ Muslim bin al-Hajjaj* (Bayrūt: Dār Ma'rifah, 1425H/2004), vol. 11, 21.

<sup>471</sup> However, the present study only selects some of evidences provided by the proponents in order to discuss briefly how the proponents argue their contention of the admissibility of *hiyal* in Islamic law. For further information of the evidences, one may refer for example to the writings of Bū Bashīsh, *al-Ḥiyāl Fiqhīyyah* and PhD dissertation's Rosman, "*Hiyal wa Makhārij*".

<sup>472</sup> Sūrah Ṣād:44, al-Hilali and Khan, *The Noble Qur'ān*, 613-614.

The action of Prophet Ayūb was considered as the exit (*al-farj wa al-makhrāj*) to implement and prevent him from infringing his oath.<sup>473</sup>

However, the above contention was rejected by Ibn Taymīyah (d. 1328) that the *ḥilah* given to Prophet Ayyub is not an absolute *ḥilah*, as he opines that the concession given to Prophet Ayyub is a specific rule prepared by God to him due to his status as a patient servant.<sup>474</sup> According to Bū Bashīsh (2005), what is meant by God in this verse is to give a relief or concession to Prophet Ayūb.<sup>475</sup> Furthermore, if the verse has shown a *ḥilah*, it must be noted that such rule was revealed before the standardization of the Sharīʿah of Prophet Muḥammad. In principle, the revealed law before Islam can be applied on condition that it must be consistent with the principle of the Sharīʿah conveyed by the Prophet. Discharging of oath in the Sharīʿah is compulsory, and violating it would impose a *kafārah* (penance/expiation). The purpose of imposing the penance is to educate, and give a moral teaching for the actor in order for him not to violate his oath.<sup>476</sup> However, if there is a *ḥilah* to exit from the rule, then there is no point for God to impose penance for those who wish to violate it.

*Ḥilah* in this regard is an intention of the *mukallaf* (capacitated person), who deliberately makes an oath to jurisprudentially exit from the rule imposed by Allāh for his irresponsible action, which is prohibited. He is inevitably required to observe the rule.<sup>477</sup> However, a question could be raised, if the person is not capable of fulfilling the oath, for example that he is very poor to pay the penance, what should be done? It is argued that a *ḥilah* can be applied and tolerated to reduce his difficulty. Despite observing the rule through a *ḥilah*, which is not consistent with the objectives of Sharīʿah, Allāh has provided an alternative to those persons that have such difficulties. If the action infringes the relationship of human being with Allāh and he is not capable of ob-

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<sup>473</sup> al-Jaṣṣāṣ, *al-Aḥkām al-Qurʿān*, vol.3, 382; Muḥammad Saʿīd Ramaḍān al-Būfī, *Dawābit al-Maṣlaḥah fī al-Sharīʿah al-Islāmīyyah* (Bayrūt: Maktabah al-Risālah, 1973), 304-305; Ṣāliḥ ibn Ismāʿīl Bū Bashīsh, *al-Ḥiyāl al-Fiqhīyah: Dawābiṭuhā wa-Taṭbīqātuhā ʿalā al-Aḥwāl al-Shakhṣīyah* (Riyāḍ: Maktabah al-Rushd, 2006), 101.

<sup>474</sup> Taqī al-Dīn Abū al-ʿAbbās Aḥmad ibn Ḥalīm ibn ʿAbd al-Salam ibn ʿAbd Allāh Ibn Taymīyah, *Kitāb Bayān al-Dalīl ʿalā Buṭlān al-Taḥlīl, Haqqāqahu wa-Kharraja Aḥādīthahu Ḥamdī ʿAbd al-Majīd al-Salaḥī* (Maktabah al-Islāmī, 1998), 276.

<sup>475</sup> Bū Bashīsh, *al-Ḥiyāl al-Fiqhīyah*, 101.

<sup>476</sup> Kamali, *Principles of Islamic Jurisprudence*, 229-233.

<sup>477</sup> Decisive oath plays important role in Islamic law, as the Prophet stipulates that the plaintiff has to prove his case through two witnesses or the defendant must take an oath. Accordingly, the Lawgiver does not allow one to ridicule with oath and if he violates or utters something, which is contrary with the oath, he must do the *kaffarah* (expiation). See ʿAbdullah ibn Abī Zayd al-Qayrawānī, “The Risālā: A Treatise on Mālikī Fiqh,” translated by Alhaj Bello Mohammad Daura, accessed 26 August 2012, [http://www.iium.edu.my/deed/lawbase/risalah\\_maliki/book31.html](http://www.iium.edu.my/deed/lawbase/risalah_maliki/book31.html).

serving the punishment stated in the *Sharī‘ah*, and then he shall be free from the penalty, however after it was evidenced by the authority that he is incapable of carrying out the punishment. This is because Allāh does not burden the human soul that cannot bear the punishment.<sup>478</sup> What is required of him is to beg for forgiveness from Allāh that he will be forgiven for his offense. This approach could be justified through the application of principle of necessity (*darūrah*) rather than to apply *hiyal* in solving the problem.<sup>479</sup> If the violation involves the relationship with humankind, it must be solved through legal means enacted by the state or ruler. The application of *hiyal* in this case is not acceptable, as it violates the rule of law. However, if the enforcement of the law clearly violates the *Maqāṣid al-Sharī‘ah* and there is no alternative except for *hiyal*, then it is permissible as the solution. This can be illustrated in the application of *bay‘ al-‘īnah* in Islamic money market in Malaysia to circumvent the prohibition of *ribā*, as there is no feasible instrument to provide the liquidity management for Islamic banks. Nonetheless, the use of *hiyal* in this respect must conform to the pillar and conditions, literally to the form, if not the essential objectives of the contract.

Furthermore, the *hilah* provided for Prophet Ayyūb was not initiated from Him, but Allāh instructed him to do so. Hence, it is not a *hilah* but an instruction from God. Moreover, the differences between concession (*rukḥṣah*) given to Prophet Ayyūb and *hilah* is immense, as the former is prescribed by Allāh based on the Qur’ān and the Sunnah, and it is closely related to an individual's ability to discharge an obligation (such as five times a day prayers and fasting in Ramadan). However, a *hilah* emanates from the executor or perpetrator’s own effort to circumvent a rule, which is not based on the prescribed rule by the Lawgiver.

Other evidence provided by the proponents of *hiyal* is based on the report of Abū Hurayrah about a person who was employed as tax collector to oversee Khaybar. He came to the Prophet with some *jānib tamar* (very quality dates). The Prophet said, “Are all the dates of Khaybar like this?” he said, “No by Allāh! O Messenger of Allāh,

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<sup>478</sup> There are various verses indicated this notion in the Qur’ān, for example. “Allāh does not burden a soul beyond that it can bear” (Sūrah al-Baqarah: 286); “Let the man of means spend according to his means: and the men whose resources are restricted, let him spend according to what Allāh has given him. Allāh puts no burden on any person beyond what He has given him. After a difficulty, Allāh will soon grant relief,” (Sūrah al-Ṭalāq:7).

<sup>479</sup> The principle of the Islamic legal maxim, “necessity permits prohibited things,” may be applied in this case. However, the application of this maxim must be prudently applied, and any random application is not acceptable. Muḥammad Muṣṭafā al-Zuhaylī, *al-Qawā‘id al-Fiqhīyyah wa Taṭbiqātihā fī al-Madhāhib al-‘Arba‘ah* (Dimāshq: Dār-al-Fikr, 2006), 276-285.

indeed we obtain one *ṣā'* (medieval Islamic measurement for weight) for two *ṣā's*, (or) two *ṣā's* for three. To which He said: Don't do that, rather sell *al-jam'* for *dirhāms*, and then buy with these *dirhāms* the *jānib*".<sup>480</sup> According to al- Jaṣṣāṣ (d. 982), the author of a well-known legal provision in the Qur'ān (*Aḥkām al-Qur'ān*), the Prophet proscribed the transaction due to *ribā al-faḍl* and taught the person to avoid such *ribā* by doing a *ḥilah* so that he could legally acquire the dates.<sup>481</sup> Meanwhile, according to al-Būṭī (1973), the *ḥadīth* unequivocally indicates the permissibility of *ḥiyal*, as it actually does not address the ordinary meaning of sale and purchase, but a *ḥilah*. This is clearly shown in the *ḥadīth*, "then buy with these *dirhāms* of the *janib* dates" for which it signifies a *ḥilah* for the increment in exchange through sale and purchase is permitted but not from the barter trade.<sup>482</sup>

However, the opinion was rejected by Ibn Taymīyah (d. 1328), as he claimed that this *ḥadīth* does not refer specifically to *ḥiyal*, instead it was an order from the Prophet to exchange the dates in accordance to sale transaction. It is not a legal artifice, but it is a pure sale and purchase transaction, by which the seller must sell the first dates and with the money gained then he purchases the second dates in order for him to avoid *ribā* transaction.<sup>483</sup> Muḥammad Rashid Riḍā (2001), a well-known Muslim scholar in the early 20<sup>th</sup> century, also refused the *ḥadīth* as a specific reference to the permissibility of *ḥiyal*. This is because the Prophet prohibited the transaction in order for the community to exchange one quantity of dates with two quantities of dates in order to avoid *ribā*.<sup>484</sup> Sale transaction is different from *ribā*, where sale involves risk and while, *ribā* does not. In fact, if we observe such arguments, the supporters attempt to employ this *ḥadīth* purposely to justify the permissibility of *bay' al-ṭinah*.<sup>485</sup> Accordingly, if the contract is permissible then it follows that *ḥiyal* is also permitted, as *bay' al-ṭinah* is part of the *ḥiyal* transaction.

Nonetheless, the opponents of *ḥiyal* of Mālikīs' and Ḥanbalīs have stringent interpretations on *ḥiyal*. Principally, the Mālikīs denounce the practice of *ḥiyal* is inconsistent with the principles of Sharī'ah. This can be explicitly observed in the utterance

<sup>480</sup> Al-Bukhārī, *Ṣaḥīḥ*, vol. 1, 407 [ḥadīth no. 2241].

<sup>481</sup> Abū Bakr Aḥmad Ibn 'Alī al-Razī al- Jaṣṣāṣ, *Aḥkām al-Qur'ān* (Bayrūt: Mu'assasah al-Tarīkh al-'Arabī, 1996), vol. 4, 392; See also al-Khaṣṣāf al-Shaybanī, *Kitāb al-Khaṣṣāf fī al-Ḥiyal*, 4.

<sup>482</sup> al-Būṭī, *Dawābit al-Maṣlaḥah*, 123.

<sup>483</sup> Ibn Taymīyah, *Kitāb Bayān al-Dalīl*, 204.

<sup>484</sup> Muḥammad Rashīd Riḍā, *Ribā wa Mu'āmalat fī al-Islām* (al-Qahirah: Maktabah al-Thaqafah al-Dīniyyah, 1421H/2001), 123.

<sup>485</sup> The present study will discuss the issue shortly next.

of Imām Mālik (d. 795) where he said, “Anyone defraud by using *hiyal*, he is a sinner”.<sup>486</sup> Al-Dusūqī (d. 1815), another Mālikīs’ scholar says that, “*hiyal* are contradicted with the decisive legal methods (*al-qawā'id al-qat'iyyah*) and the explicit definitive texts (*ẓawāhir al-nuṣūṣ al-haqīyyah*) of Sharī'ah”. This can be illustrated as one lends to a person of some of his property and he then makes the borrower promises to pay him certain amount of money when the property is rendered to him, or to give a piece of land in order for him to cultivate the land. He utilises the benefit of the items, as long as, the loaned property is held under the borrower’s obligation”.<sup>487</sup>

Al-Shāṭibī (d. 1388) furthermore adds that the implementation of *hiyal* on the legal ruling of Sharī'ah is void (*batil*), since the intent of the actor of the *hiyal* is contrary to the purpose of the legal provisions (*qaṣd al-shar'ī*).<sup>488</sup> He regards *hiyal* as an action of a *mukallaf* (capacitated person) who employs certain means to escape an obligation or to make some forbidden things permissible or to cause an obligatory thing to become ostensibly non-obligatory, or to produce a forbidden thing to become permissible, which is also known as *ḥilah* or *taḥayyul*.<sup>489</sup> *Taḥayyul* works on two premises; firstly, it strives to transfer the value of one legal act to another legal act externally, i.e. merely based on apparent similarity between the two acts. Secondly, it neglects the inner meaning (i.e. *maṣlaḥah*), of the acts on the basis of which the acts were originally intended by the Sharī'ah, and by doing so reduces the value of these acts to be means to certain other acts, whereas they were meant to the end”.<sup>490</sup> In this regards, one who resorts to employing *hiyal* to defeat the objective of Sharī'ah, his *hiyal* would be considered as void *hiyal* or prohibited *hiyal*. If the person intends to violate an explicit Law-giver’s injunction, his action is regarded as incoherent with the Sharī'ah, which is also void.<sup>491</sup> The prohibited *hiyal* could be assessed by evaluating the ‘end-result’ and ‘cause and effect’ of an action. Employing *hiyal* that apparently is in non-conformity or eliminating the legal ruling of an action or altering the legal ruling of an action to another is regarded as damaging the Sharī'ah principles. In the same vein, having a factor

<sup>486</sup> Ibn Taymīyah, *Kitāb Bayān al-Dalīl*, 33.

<sup>487</sup> Muḥammad ibn Aḥmad ibn 'Arafah al-Dasūqī, *Hāshīyyah al-Dusūqī 'alā Sharḥ al-Kabīr* (Bayrūt: Dār al-Kutub al- 'Ilmī, 1996), vol. 6, 46.

<sup>488</sup> al-Shāṭibī, *al-Muwāfaqāt*, vol.2, 339

<sup>489</sup> Muḥammad Khālīd Mas 'ūd, “Shāṭibī’s Philosophy of Islamic Law: An Analytical Study of Shāṭibī’s Concept of Maṣlaḥa in Relation to His Doctrinal of Maqāṣid al-Sharī'a with Particular Reference to the Problem of Adaptability of Islamic Legal Theory to Social Change,” (PhD diss., University of McGill, 1973), 354.

<sup>490</sup> Al-Shāṭibī, *al-Muwāfaqāt*, vol.2, 339; Ibid., Mas 'ūd, “Shāṭibī’s Philosophy of Islamic Law,” 354.

<sup>491</sup> Al-Shāṭibī, *al-Muwāfaqāt*, vol.2, 231.



that is recognized as a cause to the action and its effect, and when the action is promulgated, the effects realised is in variance with the objectives that have been laid down by the Lawgiver, is also regarded as prohibited.<sup>492</sup> He also asserts that the absence of legal intention in a contract or action also leads to a void deed. In this respect, intention and purpose play important roles in formulating contract. When the contractor intends other than the meaning of the contract, he could no longer be regarded as intending to achieve the purpose of the contract legally, since the effects of contracts depend on the approval of the Lawgiver and not the intention of the contractor.<sup>493</sup>

In the same aptitude, the Ḥanbalīs seemed to oppose generally the genre of *ḥiyal* in Sharī‘ah and this can be illustrated in the word of Imam Aḥmad, “it is not permitted to do something by using *ḥiyal*”. For example, “if someone swore to do something, then he defrauds by using *ḥiyal* upon the matter then he becomes part of it of the deceiver group of *ḥiyal*”.<sup>494</sup> Ibn Baṭṭah (d. 997) said that it is prohibited to use *ḥilah* upon the legal provisions of God and His religion, and if he does the *ḥiyal* in order for him to deceive the provisions of God and His messenger, he does not cheat them, i.e. God and Messenger but himself.<sup>495</sup> Ibn Qudāmah (d. 1223), in the same vein, addresses the illegality of all devices and that they are impermissible to any matter in the religion.<sup>496</sup> Ibn Taymīyah (d. 1328) also says that *ḥilah*, which proposes to escape from the obligation and to allow the prohibition by doing something (contrary), which is not necessary or what is prescribed for it to make it valid. It is a deception to God Almighty, and mockery of the revelations and manipulating the legal provision of God.<sup>497</sup>

Among the proofs to corroborate their justifications of the prohibition of employing *ḥiyal* is the proof of God says concerning the ruses of Jews in several verses. In Sūrah al-‘A ‘rāf:163, Allāh said, “And ask them (O Muḥammad) about the (population i.e. Jews people) of the town that was (near) by the sea, when they transgressed in the matter of the Sabbath, when the fish came to them openly on the Sabbath day, and did not come to them on the day had no Sabbath. Thus, we made of them, for they used to rebel against Allāh’s Command (disobey Allāh)”.<sup>498</sup> Al- Jaṣṣāṣ (d. 982) comments that

<sup>492</sup> Ibid, vol. 2, 201, 278.

<sup>493</sup> Ibid., vol. 1, 216, 330.

<sup>494</sup> Ibn Taymīyah, *Kitāb Bayān al-Dalīl*, 32.

<sup>495</sup> ‘Ubayd Allāh ibn Muḥammad Ibn Baṭṭah, *Ibṭāl al-Ḥiyal* (Bayrūt: Mu’assasah al-Risālah, 1996), 32.

<sup>496</sup> Ibn Qudāmah, *al-Mughnī*, vol. 4, 41.

<sup>497</sup> Ibn Taymīyah, *Kitāb Bayān al-Dalīl*, 32.

<sup>498</sup> Sūrah al-‘A ‘rāf: 163, al-Hilali and Khan, *The Noble Qur’ān*, 224.

God prohibited the Jews to catch fish on Sabbath, but they made a *ḥilah* by putting nets before the day of Sabbath and pick up the fish on the next day (Sunday). If the deed is not prohibited, that is by putting nets on the Sabbath, thus God will not punish them, but God still punished them because of the deed. This was corroborated in the Sūrah al-Baqarah: 65 “And indeed you knew those amongst you who transgressed in the matter of Sabbath. We said to them, “be you monkeys, despised and rejected”.<sup>499</sup>

In the similar vein, the Prophet also said, “Allāh has cursed the Jews who have been banned from eating fat (from cow) but they altered the fat to become other form, by melting it and sell it”. Generally, this *ḥadīth* expresses that God has cursed the Jews who use tricks in justifying the prohibition of using animal fat.<sup>500</sup> This Qur’ānic proof was accepted as a legal proof for the illegality of *ḥiyal*. According to Bū Bashīsh (2005), this *ḥadīth* has shown a decisive legal proof (*dilalah qat’iyyah*) that if *ḥiyal* are used either through unlawful means such as providing dishonest witness in order to prove ownership or through lawful means such as illustrated in the above *ḥadīth*, the *ḥiyal* are still prohibited in the Sharī‘ah. Such *ḥiyal* may cause great harm and damages to the Sharī‘ah legal methods (*qawā‘id al-shar‘iyyah*) in deducing legal ruling.<sup>501</sup>

Another argument made by the opponents of *ḥiyal* is that the prohibition of *ḥiyal* is advocated because the practice is contrary to a *ḥadīth* narrated by Umar ibn al-Khattab, who said that, “I heard the Prophet said: “Actions are judged, but by intention and there is for every person only that which he intended”.<sup>502</sup> This *ḥadīth* clearly indicates that an act follows an intent and purpose. If the original intent or purpose of an act is wicked or bad, then the act resulting from such purpose is null and void. Ibn Qayyim (d. 1350) noted that any action must follow purposes and intention and that the actions are not arbitrated by their outward forms instead by the intention and interior purposes they follow.<sup>503</sup> In this regard, the said *ḥadīth* of al-Bukhārī (d. 870) in this context is imperative as it emphasizes that all deeds are gauged by intention and this proof is taken by the *ḥiyal* opponents for application into the religious context as well as in the civil matters.<sup>504</sup>

<sup>499</sup> Sūrah al-Baqarah: 65, al-Hilali and Khan, *The Noble Qur’ān*, 14; al-Jaṣṣāṣ, *Aḥkām al-Qur’ān*, vol.4, 393.

<sup>500</sup> Ḥadīth *Ṣaḥīḥ*, Muḥammad Ibn Ismā‘īl al-Bukhārī, *Ṣaḥīḥ al-Bukhārī* (Riyad: al-Maktabah al-Ma‘ārif lil an-Nashr wa Tawzī‘, 2002), vol. 3, 1275.

<sup>501</sup> Bū Bashīsh, *al-Ḥiyal Fiqhīyyah*, 108.

<sup>502</sup> al-Bukhārī, *Ṣaḥīḥ al-Bukhārī*, vol. 1, 5 (ḥadīth no. 1).

<sup>503</sup> Ibn Qayyim al-Jawzīyyah, *I‘lām al-Muwaqqi‘īn*, vol. 3, 122.

<sup>504</sup> Ibid.

#### 4.4. Permissible and Prohibited *Ḥiyal*

In light of preceding discussions, there were various opinions of *ḥiyal* discussed by Sharīʿah scholars, which sometime become a juristic dilemma for practitioners in the field of Islamic banking industry, since which view should be adopted as a standard to be practiced. For the opponents of *ḥiyal*, they have held that the practice of *ḥiyal* is obviously unlawful in the Sharīʿah framework. To some extent, not all of these jurists especially from the Ḥanafīs and the Shāfiʿīs and even some scholars from the Mālikīs and the Ḥanbalīs have denounced that all *ḥiyal* to be falling under unlawful category. They attempt to categorise *ḥiyal* into permissible and impermissible types. According to Mahmasani (1987), permissible *ḥiyal* represent an attempt to utilise a legal device laid down for a definite purpose to attain another purpose targeting to uphold a right, prevent injury, or ease a situation owing to necessity. Meanwhile, impermissible/prohibited *ḥiyal* are legal artifices intended to change well-established *fiqh* rules into different rules through an action, which is ostensibly correct but implicitly void.<sup>505</sup> As such, since the connotation of *ḥiyal* constitutes a general meaning, which encompasses prohibited and permissible *ḥiyal*, the term *makhārij* has been coined especially by the Ḥanafī scholars to refer to good/permissible *ḥiyal*. As the *ḥiyal/makhārij* binary is subtle, particularly because the two concepts are two-sides of a single coin, it requires in-depth explanation. The following section will attempt to state what scholars deem as prohibited/impermissible *ḥiyal* to offer a clear contrast between the two nuanced concepts.

The Ḥanafī jurists are more liberal in permitting the practice of *ḥiyal* in Sharīʿah, which is similar to *makhārij* or jurisprudential exits (sing. *makhraj*). Even so, they argued that the use of these exits is not therefore absolute, but rather qualified, in that, only if they are used to save a person from doing a prohibited action, or provide him with a permissible route. However, those, which are used to appropriate the rights of others or create doubts about them or to conceal an invalid act, are regarded as reprehensible (*makrūh*). This is because in certain circumstances *ḥiyal* are used to deny the principles of Sharīʿah, which are explicitly known. Moreover, in the understanding of the Ḥanafīs, each Islamic law or prohibition specified by the Lawgiver, in the Qurʾānic

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<sup>505</sup> Subhi Mahmassani, *The Philosophy of Jurisprudence in Islam*, translated by Farhat J. Ziadeh (Kuala Lumpur: Penerbitan Hizbi, 1987), 120-121.

verses or the Prophetic traditions has a jurisprudential exit (*makhraj*). If we detest this exit then we have detested the Sharī‘ah rules, which have been stated clearly.<sup>506</sup> For example, the Lawgiver forbids fornication (*zina*) and the exit for it is marriage. Similarly, the Lawgiver forbids transactions of *ribā* and the exit for it is to do business (*bay‘*).

According to Horii (2002), the position taken by the Ḥanafīs on *ḥiyal* is not used to deviate or circumvent the law, but to circumvent difficulty in the case of necessity or emergency (*darūrah*), which involves life and death situation. In such situations, one is permitted to seek solutions or remedies, i.e. *makhārij*. Hence, it is permissible for an action to circumvent the difficulty.<sup>507</sup> This claim, she argues, attempts to reject the opinion of Schacht that implies that *ḥiyal* are used as a *modus vivendi* or to bridge of the ideal and realities of Sharī‘ah.<sup>508</sup> In the case of oppression, for example, one is relaxed to deceive the oppressor with equivocal words (*ma‘ārīd al-kalām*) that the oppressor cannot imagine, which aims to defend himself from any injuries and perils. This conception was significant as it was used in the jurisprudential methods of the Ḥanafīs, where they only ‘prescribed’ the *makhārij* instead of creating special devices to evade the provisions of Sharī‘ah.<sup>509</sup> Furthermore, she asserted that the concept of *ḥiyal* is an essential element to Sharī‘ah and part of it, and she called the supporters of this notion as the ‘*makhārij*-group’. The notion of ‘*makhārij*’ is more related to a relaxation of strict interpretation of the law, which comes close to the concept of concession (*rukḥṣah*). The use of *ḥiyal* must be based on strong and good justifications that *ipso facto* be legally permitted by the Sharī‘ah.<sup>510</sup> This can be illustrated when al-Shaybānī (d. 804/805) was asked regarding an agent who had been entrusted to purchase or sell an object, whether it is reprehensible to use a *ḥilah* for the agent to acquire the object for himself. In response to the inquiry, he said that *ḥilah* could not be employed to something deemed reprehensible to the religion of Islam. In other words, a permissible

<sup>506</sup> al-Sarakhsī, *Kitāb al-Ḥiyal*, 88.

<sup>507</sup> Horii, “Reconsideration of Legal Devices,” 322.

<sup>508</sup> In Schacht’s argument, Islamic law is regarded so idealistic, where it could not address the real life of Muslim society. Hence, by using *ḥiyal* methods or bogus transactions, Islamic law could be linked between the theory and social practice. Schacht, *An Introduction*, 79-81.

<sup>509</sup> This idea is strongly opposed to the understanding of *ḥiyal* by Schacht, in which he believes that *ḥiyal* is a genre to bridge the ‘ideal’ theory and practice of Sharī‘ah law, which he also understood the law has no influence upon social life. Schacht, *An Introduction to Islamic Law*, 79-81.

<sup>510</sup> Ibid, 319 and 322.

*hilah* can be used only to pursue a legal course, which seeks to either ease a difficulty or correct what is unlawful.<sup>511</sup>

However, the argument made by Horii (2002) that the concept of *makhārij* is close to the concept of *rukḥṣah* is partially incorrect. Both terms are different in the legal connotation under the Sharī‘ah law. *Rukḥṣah* (pl. *rukhaṣ*) literally means comfort, concession, alleviation, and convenience. *Rukḥṣah* is opposite to the words liability, aggravation, exacerbation, augmentation, and intensification. There are several definitions given by the Muslim jurists of *rukḥṣah*. Among others, it is a permission to leave certain compulsory obligations and duties - the alleviation of rules - due to illness or disability, which is recognized by the Sharī‘ah. As a well-known example, a person who is in travel may shorten his prayer from four to two prostrations (*raka‘at*), and may combine two prayers in a single prayer or a bed-ridden person may perform a prayer, while lying on his bed without standing. However, if the performer has no reasonable Sharī‘ah-accepted justification and he is a fit person, abandoning the mandatory obligations prescribed in the Sharī‘ah is regarded as a forbidden act.<sup>512</sup>

Similarly, as well, there are instances where an illegal act may be exceptionally made legal. Thus, it is also defined as legitimising the illegal act even though there is legal evidence (*dalīl*) that prohibits the act, due to certain circumstances that precludes it from the original rule.<sup>513</sup> An example of a concession given to an illegal act is the permission to utter the words of *kufur* (blasphemy) when a Muslim is under coercion to do so, while his heart still maintains the faith. The disability that allows *rukḥṣah* in this regard is the existence of an element of coercion or duress, while the original rule is that it is forbidden for Muslim to express blasphemy. This is based on Sūrah al-Naḥl, 106, “Whoever disbelieves in Allāh after his belief, except him who is forced thereto and whose heart is at rest with Faith”.<sup>514</sup> In summary, *rukḥṣah* is an exception and concession given by the *Sharī‘ah* from the observation of strict rule (i.e. *al-‘azīmah*). It has some similarities and differences in comparison with *hilah*. The similarity is that these two terms lead to a change from one rule to another. *Rukḥṣah* converts the obser-

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<sup>511</sup> Al-Sarakhsī, *al-Mabsūt*, vol.2, 66; Horii, “Reconsideration of Legal Devices,” 322.

<sup>512</sup> Muḥammad ibn Bahādur Al-Zarkashī, *al-Baḥr al-Muḥīṭ fī Uṣūl al-Fiqh* (al-Kuwayt: Wizārat al-Awqāf wa al-Shu‘ūn al-Islāmīyah, 1992), vol.1, 407.

<sup>513</sup> Mustapha Sano Koutoub, *Mu‘jam Muṣṭalahāt Uṣūl al-Fiqh* (Bayrūt: Dār al-Fikr, 2000), 217.

<sup>514</sup> Muḥammad Taqī Ud-Dīn al-Hilālī and Muḥammad Muḥsin Khan, *The Noble Qur‘ān: English Translation of the Meaning and Commentary* (Kingdom of Saudi Arabia: King Fahad Complex for the Printing of the Holy Qur‘ān, 1998/1419H), 364.

vation of strict rule (*al-‘azīmah*) to another rule that is less burdensome, easier, and more convenient. However, the difference is that *rukḥṣah* is based on explicit evidence that stems from the foundational texts, whereas *ḥilah* is not based on the texts, but is a clever solution thought of by Muslim jurists to circumscribe the original ruling of Sharī‘ah.<sup>515</sup> Hence, it is not appropriate in this context to use *rukḥṣah* to justify the concept of *makhārij* applied or to justify the legality of *ḥiyal*.

According to Horii (2002), the Mālikīs also recognize the use of *ḥiyal* in Sharī‘ah, but in a different way, as compared to the Ḥanafīs, which is also comparable to the concept of *makhārij*, as explained above. This can be marked in few cases included *al-Mudawwanah* written by al-Sahnūn (d. 854), where some of the *ḥiyal* are contrasting and others are identical to the Ḥanafīs’ *ḥiyal*. For example in the case of capital for *muḍārabah*, where, the Mālikīs are similar to the Ḥanafīs, they do not recognize the capital as being in the form of goods but only in cash form. In *Mudawwanah*, it was suggested by Sahnūn (d. 854) that the investor assigns goods to his partner then he sells them and uses the profits of the sale as capital for the *muḍārabah*. According to the Ḥanafīs, this type of *muḍārabah* has never taken effect and it is deemed as hire contract. Thus, they suggest that the investor needs to sell goods to the third party and uses the proceeds as capital for the *muḍārabah*. It is concluded that although the Mālikīs employ the principle of *sadd dharā‘ī* in order to prevent any action that was presumed harmful; they too pursued solutions drawn from their interpretation of the material of jurisprudence, if the principle did not provide them with solutions that are different from the Ḥanafīs.<sup>516</sup>

Despite strong opposition to *ḥiyal*, some Ḥanbalīs and Mālikīs scholars do not totally reject the practice of *ḥiyal*. For example, according to Ibn Taymīyah (d. 1328), not all *ḥiyal* are unlawful, as he also accepts numerous *ḥiyal*, which do not violate the purpose of Sharī‘ah. These *ḥiyal*, according to him, do not fall under the purview of what he is referring to as *ḥiyal* in his refutations. In this respect, he gives an example of equivocal speech, where he asserts that it is subjected to the five-fold scale of legal values (*al-aḥkām al-khamsah*). It would be obligatory (*wājib*), if someone used it in order to prevent a killer to kill him. In other situations, it may be recommended (*mustaḥab*)

<sup>515</sup> Abdul Kadir, *et.al*, “Parameter Ḥiyal,” 9.

<sup>516</sup> ‘Abd al-Salām ibn Sa‘īd Sahnūn, *al-Mudawwanah al-Kubrā lil-Imām Mālik ibn Anas al-Aṣḥabī* (Al-Qāhirah: Dār al-Nadīr, 1905), vol. VI, 20, 86, 87, 273, 350; Horii, “Reconsideration of Legal Devices,” 353-357.

or permissible (*mubāḥ*), alternatively though it may also be prohibited, especially in situations where complete disclosure is necessary. The discerning factor he invokes is the presence of a *maṣlaḥa*, i.e. the prevention of harm, either for the listener or for the speaker.<sup>517</sup> Meanwhile, for the controversial *ḥiyal*, he refers to the example of *taḥlīl* marriage (to make the divorcee of a third divorce, either husband or wife back to the first spouse), *bay' al-ṭinah* contract and occasionally *zakat* (almsgiving) and *shuf'ah* (pre-emption).<sup>518</sup> It is clear that what Ibn Taymīyah (d. 1328) is opposed to is a limited number of *ḥiyal* that eliminate the real purpose of Sharī'ah and not the genre of *ḥiyal* in its entirety. This can be discerned by Ibn Taymīyah's reference to the good *ḥiyal* (*al-ḥiyal al-ḥasanah*) and more clearly by the large number of *ḥiyal* propositioned by his disciple Ibn Qayyim (d.1350) of this type of *ḥiyal*.<sup>519</sup> Accordingly, these *ḥiyal* are evaluated according to the purpose for which they are invoked; if the intention is good then the *ḥilah* is also good and if it is corrupted then the *ḥilah* is corrupted. Nonetheless, he terms both the permissible and the prohibited *ḥiyal*, by the same word, which may complicate the understanding of the nature of *ḥiyal*. Ibn Taymīyah failed to coin that what he meant as *al-ḥiyal al-ḥasanah* are referred to as *makhārij*.

In addition, al-Shāṭibī (d. 1388) also does not totally reject *ḥiyal*. He recognizes good *ḥiyal*, which are not contrary to the purpose of Sharī'ah. This can be illustrated in the case of uttering phrases of unbelief under duress to preserve life. However, he disagrees with some *ḥiyal*, namely *nikāḥ al-muḥallīl* or *taḥlīl* and *bay' al-ājal* (sales on credit) in which he finds that it is impossible to decide in favour of or against of the two *ḥiyal*. He opines that those who regard both *ḥiyal* as forbidden believe that they are againsts the *maṣlaḥah*. However, he only provides the arguments of those who are in favour of these two *ḥiyal*, and neglect to give the opinion on those against them. On the *nikāḥ al-muḥallīl*, for example, he argues that the *ḥilah* is observed to be perfect agreement with the intention of the law.<sup>520</sup> The arrangement of the second marriage is

<sup>517</sup> Ibn Taymiyya, *Bayān al-Dalīl*, 116-117; Muhammed Imran Ismail, "Legal Stratagems (*Ḥiyal*) and Usury in Islamic Commercial Law," (PhD diss., University of Birmingham, 2010), 104.

<sup>518</sup> al-Sarakhsī, *Kitāb al-Ḥiyal*, 106

<sup>519</sup> He has written about over one hundred pages in his *I'lām al-Muwaqqi'īn* and <sup>519</sup> and over eighty pages in his *Ighāthat al-Lahfān*. Ibn Qayyim al-Jawziyyah, *I'lām al-Muwaqqi'īn*, vol.3, 723; Muḥammad ibn Abī Bakr Ibn Qayyim al-Jawziyyah, *Ighāthat al-Lahfān min Maṣāyid al-Shayṭān* (al-Qāhirah: Maktabah al-Thaqafah al-Dīniyyah, 2001), 302; Ismail, "Legal Stratagems (*Ḥiyal*), 109.

<sup>520</sup> Mas'ūd, "Shāṭibī's Philosophy of Islamic Law, 356.

to make the woman enter into a sexual relationship with another man to deter the husband from rushing into divorcing his wife if he does not indeed wish to do so.<sup>521</sup>

In addition, Sadique (2008), a contemporary scholar argues that the permissible *hiyal* are those that are for establishing a right, repelling a wrong, fulfilling an obligation, or avoiding a prohibition, where the objective of the Lawgiver is fulfilled through employing a legally acceptable means.<sup>522</sup> Thus, *hiyal* in this case could be referred to as unobtrusive methods permitted in the Sharī‘ah, which facilitate the attainment of benefit or repelling harm, without sacrificing the objectives of Sharī‘ah. Based on this, the permitted *hiyal* are noted to comprise of three features: first, the methods used are of a concealed nature, either due to its exterior being different from the interior, or due to it being naturally obscure, thus not usually drawing attention. Second, the methods used are lawful in Sharī‘ah, i.e. do not breach the rights of God or men. Finally, the purpose intended must be legally recognized in Sharī‘ah.<sup>523</sup>

From the foregoing, Sharī‘ah scholars seem to agree that the only permitted *hiyal* in the Sharī‘ah is *makhārij*, which are defined as the means to a way out from illegal matters or to resolve the difficulty and hardship faced by someone, where he could not carry out his duties as a Muslim.<sup>524</sup> In this respect, it is permissible for him to circumvent the rule of Sharī‘ah. For example, someone, who is in condition of difficulty to give *naḥqah* (maintenance’s money) to his family and at the same time, there is nobody that would give him a benevolent loan therefore; Muslim jurists regard that he may use *‘inah* (sale and repurchase) or *tawarrūq* to acquire loan to give the *naḥqah* to his family.<sup>525</sup> Another definition of *makhārij* is that they are solutions that circumvent a difficulty in order to achieve the objectives of Sharī‘ah. Hence, *hiyal* are permitted as long as they preserve the objectives of Sharī‘ah, *ḍarūriyyāt* (essentials), *ḥajīyyāt* (necessities) and *taḥsiniyyāt* (embellishments).<sup>526</sup> However, it is a challenging task to determine which *hiyal* fall under which category, since it depends on the circumstances, place and time as well as the intention of the contracting parties.

<sup>521</sup> Al-Shāṭibī, *al-Muwāfaqāt*, vol.2, 281-285; Wael B. Hallaq, *A History of Islamic Legal Theories* (Cambridge: Cambridge University Press, 1997), 187-188.

<sup>522</sup> Sadique, “Early Juristic Approaches to the Application of Ḥiyal,” 160

<sup>523</sup> Fatwā no.1324, Fatāwā Dār al-Iftā (al-Qāhirah: al-Majlis al-‘Ala li al-Shu’ūn al-Islāmīyah, n.d.)

<sup>524</sup> . The term of *hiyal* constitutes a general meaning, which encompasses prohibited and permissible *hiyal*, whereas *makhārij* specifically refer to good *hiyal*.

<sup>525</sup> Wizārat al-Awqāf wa al-Shu’ūn al-Islāmīyah, *al-Mawsū‘ah al-Fiqhīyah*, vol.36, 240.

<sup>526</sup> Muḥammad ibn Ibrāhīm, *Al-Ḥiyal al-Fiqhīyah fī al- Mu‘āmalāt al-Maliyyah* (Tunisia: Dār Suḥnūn, 2009), 9; Sālih Ismā‘īl, *Al-Ḥiyal al-Fiqhīyah: Qawā‘iduhā wa Taṭbiqatuhā ‘alā al-Aḥwāl al-Shakhṣīyah* (al-Qāhirah: Maktabah al-Rushd, 2005), 28



In this respect, further discussions have extended the argument and suggested that the permissible *hiyal* or *makhārij* could be categorized into two types. First, *hiyal*, which serve to achieve a legal objective, are not known as *hiyal* in a linguistic manner. For instance, a clear means of expression that is spelt-out to conclude a contract of sale or lease, guarantee, forward sale and various types of options, purposely accomplish its legal objective in an obvious procedure. Second, *hiyal* that work in obscure means to realize a different objective that is legally recognized in the Sharī‘ah, is also permitted, for example oblique speech to avoid the utterer from be killed, is permissible as it serves the objective of preserving of life, one of the essential *maqāṣid*’s components.<sup>527</sup> These two types of *hiyal* are recognized in the Sharī‘ah by virtue of the results of the *hiyal* that uphold the objectives of Sharī‘ah.

The differentiation between *hiyal* and *makhārij* is further explained by Rosman (2008). He argued that the concept of *hiyal* in specific meaning refers to a deed of legal disposition that is originally permissible in the Sharī‘ah. However, it only becomes a problem, when the performer of the deed does not intend to achieve the original rule prescribed in the Sharī‘ah, instead he adopts them as a means to act against or to alter the legal rule to another rule. *Hiyal* in this case is associated with a disputed legal connotation that the performer wishes to modify the established legal rule in the Sharī‘ah. The majority of Muslim jurists in this respect disputed its position and legal ruling (*hukm*) in the Sharī‘ah<sup>528</sup>. On the other hand, the concept of *makhārij* refers to a deed of legal disposition intended to achieve greater benefits or to eliminate harms that happened or will happen, that does not result in any changes to the original legal ruling prescribed by the Lawgiver. Majority of Muslim jurists in this respect agree that this kind of disposition is permissible. He then illustrates the idea with an example that when A lends RM1, 000 to B, and at the time of payment, B gives the principal of RM1, 000 with an extra amount of RM100, as a gift due to the generosity of A in giving him a benevolent loan previously. This transaction is seen as permissible because the gift is not stipulated in the loan transaction.<sup>529</sup> However, the illustration given is not coherent with the concept of *makhārij*, which is employed to circumvent the difficulties or hardships. In this respect, the example given, in the IFIs that a product developer may combine a loan contract with a *hadiyah* contract is not justified, which difficulties

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<sup>527</sup> Ibid.

<sup>528</sup> Rosman, “*Hiyal wa Makhārij*, 26-42.

<sup>529</sup> Ibid.

faced by Islamic banks. It is clear here that the intention here would not be freely chosen expression of gratitude from the borrower, but a binding clause to ensure profit for the lender, where the end-result of the transaction is to ensure that the bank makes a profit through what seems to be a Sharī'ah-compliant contract. The initial scenario describes an instance of *makhraj*, whereas the second describes as instance of *ḥilah*.

To sum up the discussions above, firstly, there is a need to differentiate between the *ḥiyal* and *makhārij*, where it is observed that they have been used interchangeably. Some scholars use *ḥiyal* interchangeably to mean *makhārij*, which may complicate the understanding of the nature of the latter term. The term *ḥiyal* signifies the general connotations of legal artifices, which may comprise of prohibited and permissible *ḥiyal*. The latter definition is also known as *makhārij*. The differences between the terms can be identified through the end-result of both, where prohibited *ḥiyal* are used to change the established legal ruling, while *makhārij* are not. The difference also can be noticed that the performer of prohibited *ḥiyal* intends to cause prohibited consequences, whereas *makhārij* are not, hence majority of Muslim jurists agree on the permissibility of *makhārij*. However, to identify the intention is difficult task and this will be discussed in the following section. Secondly, the permissibility to circumvent the rules of the Sharī'ah is only allowed, when it is accompanied with strong *Shar'ī* justifications that there are some difficulties, hardships, or harms happened that may endanger the objectives of Sharī'ah; the preservation of five values of *ḍarūriyāt*; religion, life, intellectual, progeny, and property.<sup>530</sup> Finally, the use of these *ḥiyal* as opposed to the *makhārij* is not regarded as normative exits, but rather, as transitory concessions. If the difficulties, hardships or harms are no longer existed, the use of these *ḥiyal* is therefore unwarranted.

#### 4.5. Intention and *Ḥiyal*

The legality of *ḥiyal* has been disputed because scholars argue that the act of performer is conflicting with the objectives of Sharī'ah. In this respect, intention or motive of the performer is the best indicator to determine whether *ḥiyal* are permitted or not. The legal concept of *niyyah* (intention) takes a prominent role in the Islamic reli-

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<sup>530</sup> *Shar'ī* justifications in this respect refer to reasons given by someone to use *ḥiyal* that are accepted under the Sharī'ah law, such as equivocal speech to prevent someone to be killed.

gion.<sup>531</sup> Generally, the Mālikīs and the Ḥanbalīs recognize that intention plays important role in *mu‘āmalat*, whereas the Ḥanafīs and the Shāfi‘īs do not. The latter two schools recognize any legal undertakings based on the appearance of the contract. They also justify their position based on a legal maxim that stated, “What is important in a contract is its form not purpose”, where the former two schools do not.<sup>532</sup> However, according to Saleh (1992), the difference between these two groups of Islamic law schools is not about the unlawful intention when it is explicitly expressed, as they also rejected this. For the Ḥanafīs and the Shāfi‘īs, contracts and transactions are always lawful in the absence of an expressed unlawful intent. This is in contrast to the Mālikīs and the Ḥanbalīs who object and nullify contracts, where the contracting parties exhibit implicitly an intention to violate the law and they consider it as irrelevant to the legal ruling.<sup>533</sup> In other words, the Ḥanafīs and the Shāfi‘īs recognize the Islamicity of a contract is based on the appearance of statements or contractual forms. Meanwhile, the Mālikīs and Ḥanbalīs’ approval is based on both elements; forms and substance of the contracts. If they are contradicted, the latter will prevail. These two legal positions undertaken are very important in Islamic banking, as the proponents of *hiyal* will justify their positions on legal artifices based mostly on the Ḥanafīs and Shāfi‘īs.

There are three components comprise in intention; namely will (*irādah*), intention (*qaṣad/niyyah*) and cause (*sabab*), which are interrelated.<sup>534</sup> Every action of a human being must stem from his will and a will is geared with intention. Meanwhile, cause supplies the reason and justification for the intention that will take place. Precisely, as asserted by Saleh (2009), intention is a mental formulation involving forethought of some possible end and the desire to seek and to attain that end. It is rarely expressed or admitted and it usually has to be inferred from circumstances and conducts, which are assigned into action by the will of the executor. While, will is the mental faculty and aptitude that plays a driving force of intention vis-à-vis the contracting party or promisor to reach a decision, either to finalize the contemplated legal act or discard it.

<sup>531</sup> Imām al-Bukhārī (d. 870) placed the first *hadith* in his book about the importance of intention. al-Bukhārī, *Ṣaḥīḥ al-Bukhārī*, vol. 1, 15.

<sup>532</sup> Nonetheless, this proof may be rejected as invalid due to Islamic legal maxims may not serve to become a proof to sanction any legal provisions in the Sharī‘ah except the maxims, which are derived from the scriptural sources of the Qur’ānic verses or Prophetic traditions. Kamali, “Legal Maxims,” 77-101.

<sup>533</sup> Nabil Saleh, “Are the Validity and Construction of Legal Acts Affected by Cause (*Sabab*)? A Comparative Study under Islamic and Arab Laws,” *Arab Law Quarterly* 7, no. 2 (1992): 125-126.

<sup>534</sup> ‘Abd al-Razzaq Aḥmad al-Sanhūrī, *Maṣādir al-Haqq Dirāsah Muqāranah bi al-Fiqh al-Gharbī* (Bayrūt: Al-Majma‘ al-‘Ilmi al-Arābī al-Islāmī, 1954), vol.4, 59; Mahmassani, *The Philosophy of Jurisprudence in Islam*, 120-121.

On the hand, cause is external or internal motives and reasons, which induces a contracting party to conclude a legal act and the aim one intends to achieve through that legal act. Cause is also understood as the immediate purpose (*al-ma'ārīd al-mubāsharah*), as indicated in the contract itself.<sup>535</sup>

When a cause is known as an immediate purpose, it means only apparent will (*al-irādah al-zāhirah*) is taken into account to assess a deed and there is no further need to explore the mental motives of the contracting parties. However, when the cause has the meaning of inducing motives (*bā'ith*) then the inner will (*al-irādah al-bāṭinah*) is taken into account. Cause is rarely discussed by Muslim jurists; instead, intention, which is the purpose of the contracting parties in bilateral contracts and of the promisor in unilateral undertaking, is more often encountered in the Islamic legal discourses. For example, when someone, promises without cause (*wa'd mujarad*), it means a voluntary undertaking, which is bereft of any motives. Thus, if person 'A' promises to pay person 'B's debt with no declaration of motive, person 'A' is not obligated to fulfil his promise, although the act to pay the debt is mandatory and obligatory.<sup>536</sup> Hence, the court of law cannot make this alleged claim without any apparent motives or clear evidence, as a proof. This is also stated in the article 1628 of the *Mejelle*, which specified that if the cause (*sabab*) of indebtedness is a mere acknowledgement of the indebtedness, i.e. an acknowledgement with no apparent motive, the alleged creditor would not be heard by the court.<sup>537</sup>

The most challenging task is to determine intention, which is good or bad. If the intention or motive are explicitly indicated through a clear expression, then the action can be judged as bad or not, but most of the times, the expression is hidden. There are many discussions on the determination of intention or motives by Muslim scholars. In this respect, the Mālikī's and the Ḥanbalī's jurists regard pious motivation and morals, as a *sine qua non* condition for the validity of legal acts. Ibn Qayyim (d.1350), for example concurs that intention in contracts does count and affect the validity and invalidi-

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<sup>535</sup> Nabil A. Saleh, "The Role of Intention (*Niyya*) Under Saudi Arabian Ḥanbalī Law," *Arab Quarterly Law*, 23 (2009): 469-475. Saleh, "Are the Validity," 116-140; Subhi Mahmasani, *The Philosophy of Jurisprudence in Islam* (Kuala Lumpur: Penerbitan Hizbi, 1987), 189.

<sup>536</sup> Majority of Muslim jurists regard that promise without cause is religiously but not legally obligated. Subhi Mahmasani, *The General Theory of the Obligation and Contract under Islamic Jurisprudence* (Bayrūt: Dār al-Fikr, 1972), 347-350;

<sup>537</sup> The *Mejelle*: Book XIV: Actions, translated by C. A. Hooper, *Arab Law Quarterly* 5, no. 2 (May, 1990): 145-156; Saleh, "Are the Validity and Construction of Legal Acts," 120.

ty of the contract.<sup>538</sup> He has delineated some rules for investigating intention. First, (i) when intention reveals itself from the wording of the act, no further inspection is needed. Second, (ii) if intention is obscure, then the cause of the act and the circumstances can replace the intention. Finally, (iii) if the intention is not found, then he adopts a similar position of the Ḥanafīs and Shāfi'īs that the act is interpreted according to the apparent meaning of the contract. The contract remains valid unless there is contrary, i.e. an explicit indication of bad intention indicated from the contracting parties.<sup>539</sup> However, the remedies proposed by Ibn Qayyim (d. 1350) remain elusive, as in reality, the contracting parties would do anything to conceal their bad intention from being exposed, as this will invalidate their contract. If the cause was identified, this is considered too late, as damage is already done and the rule of Sharī'ah is violated, and the prevention of the act prior to examination of the cause of the act is preferable rather to remedy the consequences.

In this respect, the Mālikīs' jurists consider that the best solution is prevention of any matters that lead to *ḥiyal* that aims to violate the law. They argue that it should be obstructed when a particular act is 'deemed' to lead to evil action. To them the question of the intention of the perpetrator is not relevant anymore to the objective of determinism of the value of the means.<sup>540</sup> This approach is known as blocking the means (*sadd al-dharā'ī*), which means shutting down the means that can lead to evil or harms.<sup>541</sup> Accordingly, a means that can be blocked is classified into four categories. First category is a means that is favourable or explicitly leads to impairment, such as drinking alcohol, which is generally known to have harmful effects and thus this is obviously prohibited in the Sharī'ah. Second category is a means that is conducive to permissible matters that are not typically employed for their detrimental effects, as they may lead to that, although their benefits are heftier than the potential damage. For example, speaking the truth to an oppressive leader is encouraged, as this reveals the

<sup>538</sup> Ibn Qayyim al-Jawzīyyah, *I'lām al-Muwaqqi'īn*, vol. 3, 96-97; al-Sanhūrī, *Maṣādir al-Haqq*, vol. 4, 71; Ossama Arabi, "Intention and Method in Sanhuri's Fiqh Cause as Ulterior Motive," *Islamic Law and Society* 4, no. 2 (1997): 218.

<sup>539</sup> Saleh, "The Role of Intention," 474.

<sup>540</sup> Kamali, *The Principles of Islamic Jurisprudence*, 311.

<sup>541</sup> Muḥammad Abū Zahra, *Uṣūl al-Fiqh* (al-Qāhirah: Dār al-Fikr al-Ghazālī, 1958), 290-292; Abū al-Walid al-Bājī: *al-Ishārāt fī Uṣūl al-Fiqh*, taḥqīq wa-ta'līq Nūr al-Dīn Mukhtār al-Khādimī; taqḍīm Muḥammad al-Sharīf al-Raḥmūnī (Bayrūt: Dār Ibn Ḥazm, 2000), 113; Said Bouheraoua, "Tawarrūq in the Banking System A Critical Analytical Study of Juristic Views on The Topic," (paper presented at Organization Of The Islamic Conference The International Islamic Fiqh Academy [19<sup>th</sup> Seminar] Sharjah Emirate United Arab Emirates, 26-30 April 2009).

truth, which may have harmful effects on him, hence this act shall not be blocked. Third category is a means that is permissible but is employed to achieve a harmful objective, such as *bay' al-ʿinah* and *tawarrūq* sales, which shall be blocked. Finally, fourth category is a means which is directed to permissible acts that is devoted without any intention of harmful effect or there is no certainty, nor even a dominant probability that the act would lead to evil, such as deferred sales (*bay' al-ajal*), which is normally used as means to procuring usury. This contract shall be permitted as long as there is no indication that it is misapplied.<sup>542</sup>

Nonetheless, the third and fourth classifications are controversial among the scholars. The proponents of *ḥiyal* argue that the third category, (a means that is permissible but is employed to achieve a harmful objective) shall not be blocked if the situation is *ḍarūrah* (necessity). For the fourth category, they also argue that although the contract is designed to violate the law, but as long as it has fulfilled the contract's pillars and conditions, it should be permitted. However, for the opponents; the Mālikīs and the Ḥanbalīs reject the above propositions, as for them, if it is presumable that the act will lead to evil consequences, it shall *a priori* be obstructed. This indicates that the schools accept the probability or *zann* as legal evidence for valid basis in deducing legal rulings. Consequently, when there is, a strong likelihood that the means would lead to an evil; it may be declared forbidden although it is based on probability alone.<sup>543</sup>

Even though, the Ḥanafīs and Shāfi'īs do not recognize the concept of *sadd dhārā'ī* as they contend that in Sharī'ah, the presumption, likelihood, probability and suspicious evidence should not be foundation to deduce legal ruling. However, both schools agreed that if the apparent statement or motives are clearly expressed in the terms of the contract, they also would rightly interdict such transaction, but not to the extent of invalidating it. This is due to, they argue that the intention of the party may change and not remain constant throughout or even after it was concluded.<sup>544</sup> For example, Imām al-Shāfi'ī does prohibit *bay' al-ʿinah* ethically as a reprehensible (*makrūh*) contract, when a corrupted intention on the part of the purchaser is not made manifest, but not to the extent of invalidating the transaction. However, if the unethical intention of the parties is obviously manifest, for example, the seller stipulates to the buyer that shall not sell the commodity sold to him to either party, except him. This is

<sup>542</sup> Kamali, *The Principles of Islamic Jurisprudence*, 314-316.

<sup>543</sup> Ibid., 315.

<sup>544</sup> Abū Zahrah, *Usul al-Fiqh*, 294.

contrary to the basic requirement of sale that when the object is sold by the seller to the buyer, the new owner has a freedom to dispose the object.<sup>545</sup>

Meanwhile, al-Sanhūrī (1950), attempts to construct two modes of legal efficacy of the subjective cause of intention, which do not appear in the contract. First, it could be noticed from dictation, declaration, or assertion of the contracting party to announce the purpose of the transaction. For example, in the case of hiring concubines for adultery, is not permitted because adultery is prohibited under the Sharī'ah law. Another example stated by him is if one purchases a male sheep or cock that stipulates to become a fighter or slave girl that stipulates to become a singer or prostitute, then such sale is also prohibited. This is because the purpose of the sale, as entertainment is conceded as a prohibited act.<sup>546</sup> From such commitments, the seller may assess the intention of executor of the transaction through the obviously utterance or expression in the initial transaction by the purchaser. Nonetheless, the flaw of this approach is that normally the executor or perpetrator would not at all explicitly express his intention, if it is to violate the literal law. If it were explicitly spoken then surely the seller would not deal with him.

The second approach is the effort to uncover the implicit or suspicious unlawful intention, which can be dictated from the subject matter (*ma'qūd 'alayh*) transacted, such as the misappropriation of a knife or a weapon to kill someone, although the purchaser does not explicitly state his motives of the transaction. Again, this is also argued by al-Sanhūrī (1954) that the approach adopted by the Abū Ḥanīfah (d. 767) and his two disciples; Abū Yūsuf (d. 798) and al-Shaybānī (d. 804/805). Some goods are not prohibited and the Qur'ān and the Sunnah are silent about them and question arises whether they are considered lawful objects when their very nature attests to possible violation of the law. For instance, musical instruments, whose main function is entertainment, raise two questions. Firstly, al-Sanhūrī (1954) asked whether the prohibition is based on objections against the physical instrument per se or against the objective of the instruments as being used for entertainment, which makes the instruments unlawful for exchange. According to Abū Ḥanīfah, the exchange of the instruments is legally recognized in the Sharī'ah provided the purchaser is silent on the purpose and use of

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<sup>545</sup> Muḥammad ibn Idrīs al-Shāfi'ī. *Kitāb al-Umm* (al-Qāhirah: n.p., 1325 AH) vol. 7, 270, as quoted in Arabi, "Intention and Method," 210.

<sup>546</sup> 'Ala' al-Dīn Abū Bakr Ibn Mas'ūd al-Kasānī, *Badā'i' al-Ṣanā'i' fī Tartīb al-Sharā'i'* (Bayrūt: Maktabah 'Ilmiyyah, n.d), vol. 4, 190; al-Sanhūrī, *Maṣādir al-Haqq*, vol. 4, 59; Arabi, "Intention and Method, 212-216.

the object, since it may be used in different ways from the normal function, such as their material constituents may serve ends other than producing melodic tunes. Meanwhile, Abū Yūsuf (d.798) and al-Shaybānī (d. 804/805) opine that the normal cause (*sabab*) for buying the instruments is sufficient proof to invalidate the sale. Arabi (1995) in this respect clarifies that although the absence of an explicit statement by the purchaser of the transaction's purpose, does not excuse him from legal accountability because the dominant intent behind the transaction is unlawful. Hence, both scholars, i.e., Abū Yūsuf (d. 798) and al-Shaybānī (d. 804/805) were inclined to prohibit such transaction.<sup>547</sup> However, the shortcoming of this approach is that the subject matter dealt with does not necessarily lead to negative or undesirable purpose, as the intention of the purchaser may change before and after the deal because it is hidden. One cannot assume the purchasing of weapon by ordinary person, is only to kill or to harm other people, but perhaps, the real intention of the purchaser is to protect his family's members and properties.

Another approach is to identify the consequences and outcomes of the contract. For example, if the initial contract concluded is sale, but it is used by perpetrator as a legal trick to circumvent the prohibited elements, then the contract can be denounced as illegal because it was concluded dissimilar to the initial intention of the contracting party. However, the deficiency of this method is that the contract has already been ensued and the precautionary element is thus considered late, since the damage or the impairment has already occurred.<sup>548</sup>

To conclude the discussion above, it can be established that identifying intention is a difficult task for any jurist or judge, since it is not easy to determine the inner intention of the contracting parties. One cannot judge someone's action solely based on their intention, as it may change abruptly, prior to or after the transaction is concluded. What can be done is to identify the intention of the parties involved through legal documentation or contracts that are normally used to circumvent the prohibition of *ribā* such as *bay' al-ṭinah*, *bay' al-wafā* and organized *tawarrūq*. These contracts are already known as *hiyal* contracts, and therefore, they are supposedly prohibited in Shari'ah, and Islamic banking and finance. Nonetheless, if they are permitted, the scope

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<sup>547</sup> Arabi, "Intention and Method," 214.

<sup>548</sup> Bouheraoua, "Tawarrūq in the Banking System."



of their applications must be restricted only in the cases of necessity (*darūrah*), in which there is no alternative can be provided, except by using these contracts.

#### 4.6. Identifying *Ḥiyal* in Islamic Commercial Transactions

*Ḥiyal* can be identified in various ways and methods. As asserted above, the presence of *ḥiyal* is difficult to be recognized in the normal sense especially by ordinary people, as *ḥiyal* are employed in a hidden or concealed method. However, there are several ways to know when *ḥiyal* are being practiced in Islamic commercial transactions.<sup>549</sup>

Firstly, *ḥiyal* can be identified, as they are used in extraordinary or unusual situations in commercial transactions. For example, in a five-year lease contract of one piece of land, a lessee's concern is probably that his lessor will terminate the contract earlier than the contract is meant to end, which will obviously causes him inconvenience, especially if he plans to lease the land for a longer period of time. Hence, the lessee attempts to persuade his lessor that the rental rate for the first, for example, five years, is low and suggest to the lessor that he may increase the rates gradually, the year after five years. Therefore, if anything happens that may probably induce the landlord to terminate the lease contract before the end of the agreement, at least he has tried to mitigate and minimize the risk faced by the lessee, where he would have only paid a small amount of fee. Similarly, the property owner is also concerned with the early termination of the lease contract made by the lessee, and he also can mitigate the risk by imposing a high rental rates in the initial years of the rental agreement and then he gradually reduces the rates in the final years of the rental agreement. If the lessee attempts to terminate the contract earlier than, which is supposed, at least the effect to the property owner is minimal. From the aforementioned example, it is observed that *ḥilah* in this case is done in an unusual situation in the *ijārah* contract, for typically the rate of rental charged is usually standardized and constant throughout the rental period.<sup>550</sup> This is permissible *ḥiyal* since both parties are not cheating or tricking with each other, instead it is employed as a risk management tool.

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<sup>549</sup> Muḥammad Ibn Ḥasan al-Shaybānī, *Al-Makhārīj fī al-Ḥiyal* (al-Qāhirah: Maktabah al-Thafaqah al-Dīniyyah, 1419H/1999), 9; Al-Sarakhsī, *al-Mabsūṭ*, vol. 30, 383; Abdul Kadir, *et.al*, "Parameter Ḥiyal," 13.

<sup>550</sup> Ibid. 14.

Another way to know *hiyal* is being employed is when the contracting parties stipulate an extra element or extra stipulations in the contract, such as an object of sale contract that is not required or may benefit to them. For example, a condition requires a buyer to return the item that he bought previously from a seller, once the original price is given back by the seller in the *bay' al- wafā* (redemption's sale). Other example is that a compulsory *hibah* to be paid to the *muḍārabah* deposit account or that a compulsory condition for the lessee to purchase the leased asset at the end of lease period. All of these stipulations are void and null from the principles of Sharī'ah.<sup>551</sup> For example in the case of sale and lease back of the *ṣukūk* (Islamic bond) structure of financing a project (e.g. a construction of highway). An aspect of *hiyalah* in this case occurs when the issuer of the *ṣukūk* promises to buy back the asset sold to investors in the declaration of default of the project or business venture.<sup>552</sup> It is observed from the micro perspective of the structure; it is seemed that only sale and lease contracts are engaged. However, from the macro perspective, the structure of the *ṣukūk* is financing, whereby the issuer is the borrower and the investors are the lender. The employment of sale and lease contracts is only to conceal the real intention of both parties to circumvent the prohibition of *ribā*.

Nonetheless, extra element in contract such as promissory undertaking has been disputed on its legality in the Sharī'ah. Sharī'ah scholar, such as al-Masri argues that it is prohibited to use promissory undertaking to structure the product as above, since the effect of promise is similar to contract. This is because the undertaking is binding and enforceable in the court of law and this effect is similar to the contract.<sup>553</sup> However, it was rejected by Muslim scholar, such as Laldin (2012) where he argues that the promissory undertaking is different from contract. Promissory undertaking is concluded separately from the main contractual arrangement.<sup>554</sup> Although it is concluded separately from the original agreement, from the overall picture of the product, the undertaking is only a *hiyalah* to evade the prohibition of *ribā*. For example in the case of *sukuk*, promise

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<sup>551</sup> See a comprehensive discussion contractual stipulation by Arabi, "Contract Stipulations (*shurūt*) in Islamic Law, 29-50.

<sup>552</sup> See an example, Ahmad Lutfi Abdul Mutalip, and Siti Fariza Edzua Jamaludin, "Structuring *Ṣukūk* *Ijārah* and *Muḍārabah*," *MIF Monthly*, accessed on 12 August 2012, [http://www.mifmonthly.com/pdf/2008/Nov/a\\_zmi.pdf](http://www.mifmonthly.com/pdf/2008/Nov/a_zmi.pdf).

<sup>553</sup> Promissory undertaking is not considered as contract, since it involves unilateral undertaking. Al-Masri, "The Binding Unilateral Promise (*Wa'd*), 29-33.

<sup>554</sup> See the argument of the permissibility of *wa'd* made out the contract, Mohammad Akram Laldin, "The Concept of Promise (*wa'd*) and Bilateral Promise in Financial Contracts," (ISRA Research Paper no. 4/2012, International Sharī'ah Research Academy, 2012)

is used to guarantee the invested capital and expected profit of the project by the client in the event of default. In this respect, it seems that both parties have signed two contracts; one is the original contract, another one is a binding force to oblige the party, besides the condition stated in the original contract.<sup>555</sup>

#### **4.7. Parameter of *Ḥiyal***

From the foregoing discussion, it is observed that the method of *ḥiyal* can be used only in restricted ways, since the in-depth understanding of the rule for its application is impermissible. In this respect, some scholars, such as Rosman (2008), Ismail (2010) and Abdul Khir (2011) have proposed some legal parameters to control its employment in Sharī'ah as well as Islamic banking.<sup>556</sup>

##### **4.7.1. *Ḥiyal* must be consistent with the objectives of Sharī'ah**

Firstly, the use of *ḥiyal* must be consistent with the objectives of Sharī'ah that are to preserve the matters of *ḍarūrīyāt* (essentials), *ḥajīyyāt* (necessities), and *taḥsinniyāt* (embellishments). If the method is applied to other than, the scope of objectives, then it is regarded as prohibited. *Ḥiyal* in the phase of *ḍarūrīyāt* must be placed in precedence than *ḥiyal* in the phase of *ḥajīyyat*. Likewise, *ḥiyal* in the phase of *ḥajīyyat* must be the main concern rather than *ḥiyal* in the phase of *taḥsinniyāt*. For example, the commodity of *murābahah*, which is based on the concept of *tawarrūq* of personal financing in Malaysia, is regarded in the phase of *ḍarūrīyāt*, since there is no alternative that can replace the product.<sup>557</sup>

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<sup>555</sup> The western law's promise is different with Islamic law of promise, since the former is regarded as a legal obligation, while the later is only a moral obligation. However, the development of Islamic law of promise has seen that it is also a legal obligation for the contracting parties. Hans Visser, *Islamic Finance: Principles and Practices* (UK, US: Massachusetts, 2009), 75.

<sup>556</sup> Ismail, "Legal Stratagems (*Ḥiyal*)", 103-104; Abdul Kadir, *et al* (2011). "Parameter *Ḥiyal* dalam Kewangan Islam," 41-53; Rosman, "*Ḥiyal wa Makhārij al-Fiqhīyyah*", 185-216.

<sup>557</sup> Abdul Kadir, *et al* (2011). "Parameter *Ḥiyal* dalam Kewangan Islam," 42.

#### 4.7.2. The intention must be in parallel with the Sharī'ah

Secondly, the intention of the performer must be consistent with the purposes of Sharī'ah and should not show any contradiction with each other. Principally, the intention of the performer must be consistent with the religious (*diyānatan*) and juridical (*qaḍā'an*) obligations. Whatever the expression of intention in practicing *ḥiyal*; the expression must be recognized in the religion as well as in the court of law. However, if there are some constraints that may affect the greater benefits (*al-maṣlaḥah al-rājiḥah*) of the society, then the recognition of *ḥiyal*'s validity at the court is sufficient, even though it is not recognized in the religion.<sup>558</sup> This can be illustrated in the case of the exchange between two currencies. It was prohibited for these two items of same genus under the category fungible items (*māl al-mithl*) to be exchanged without spot delivery and unequal quantity. However, it is permissible, if the intention of the exchange is to give a benevolent loan. The difference between the cases is the intention of the parties, whereas the sale contract is commercial and intends to gain profit and benefit, the loan contract is a benevolent contract.<sup>559</sup>

#### 4.7.3. The means and ends must not contrary

Another parameter is that the means (*wasā'il*) to do *ḥiyal* must not be contrary to the end objectives of Sharī'ah. Means are only ways to achieve the ends or objectives of one deal, and if it is contrary to the principle of the ends, then it must be obstructed, since the ends do not justify the means. For example, the end objective of sale transaction is transferring the ownership. If there is a way to block of the handover of the genuine ownership to the real owner, then the means is invalid. This can be illustrated in the function of special purpose vehicle in *ṣukūk* that holds the beneficial ownership. When the issuer of *ṣukūk* is default, it is supposed that the investors have a right to sell off the asset that they hold. However, they could not do that because the ownership that they hold is only beneficial ownership, not the legal ownership. In this case, the issuer will purchase the asset back through purchase undertaking. This practice is

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<sup>558</sup> Ibid., 43.

<sup>559</sup> Ismail, "Legal Stratagems (*Hiyal*)," 108-109.

void in Sharī'ah because it obstructs the real ownership from using his legal right that he may dispose the asset to whom he wishes.<sup>560</sup>

#### 4.7.4. *Ḥiyal* must be public interests

Next parameter is that the *maṣlaḥah* (public benefits) that is to be achieved through *ḥiyal* must have preponderant public benefits (*al-maṣlaḥah rājiḥah*) to the community. The public benefits attained by the society and community prevail over the benefits profited by the individuals. In other words, if the benefits only serve the individual or certain organization or one group in the society, then that *maṣlaḥah* is not recognized in the Sharī'ah. It is otherwise, if the *maṣlaḥah* aims to achieve the purpose for the large group or a majority faction in the society or the whole entity of the economic system, then that *maṣlaḥah* is accepted in the Sharī'ah. For example, in the case of *bay' al- 'īnah* practiced in Malaysia, although it has been prohibited by majority of scholars. Sharī'ah scholars in Malaysia justifies that the contract is still required in the society especially for personal financing facility and liquidity management for Islamic banks. It is permitted, since there is no alternative to replace the contract, although it has been debated that it is a prohibited *ḥilah* instrument.<sup>561</sup>

#### 4.7.5. *Ḥiyal* must not be employed for long-term solution

Furthermore, *ḥiyal* approved by the Sharī'ah bodies or *mufīṭ* or any legal Sharī'ah entity for the purpose of short period of solutions shall not be used in the long term. If there is a feasible alternative that can substitute the *ḥiyal* instruments, then the *ḥiyal* should not be further applied. This can be shown in the practice of adding extra element that is not required for validating the contract. For example, aluminium is use in the *tawarrūq* structure for car financing is not relevant, since it is not required for the

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<sup>560</sup> Ibid. 44.

<sup>561</sup> Shamsiah Mohamad, "Isu-Isu dalam Penggunaan Bai'al- 'īnah dan Tawarrūq: Perspektif Hukum (Issues in the Application of Bay' al- 'īnah and Tawarrūq: Islamic Legal Perspective ,," in *Muzakarah Cendekiawan Syariah Nusantara 2006 –Bai al- 'īnah dan Tawarrūq: Isu-Isu dan Penyelesaiannya dalam Konteks Kewangan Islam*, 28 -29 Jun 2006, Langkawi (Kuala Lumpur: Bank Negara Malaysia, 2006), 70.

financing. Other alternative contracts, such as *ijārah*, *murābahah* or *mushārahah mutanāqishah*, would have been more practical contracts for the purpose.<sup>562</sup>

#### 4.7.6. Prohibited *hiyal* must be blocked

Finally, *hiyal* that are categorized under prohibited *hiyal* should be blocked (*sadd al-dharā'ī*) in order to avoid any circumvention of *ribā*.<sup>563</sup> In this respect, the concept of *sadd al-dharā'ī* is related to the means that can lead evil and harms to the Sharī'ah. Ibn Taymīyah (d. 1328) divides the means into three types. Firstly, the inevitable means that leads to the unlawful consequences, which are prohibited. Secondly, the means, which probably would not lead to the prohibited, but generally and normally do so, is also prohibited. Thirdly, the means that only sometimes leads to the illicit result. However, if the means that results to achieve greater benefits to the society, then it is permitted otherwise this too is prohibited.<sup>564</sup> Accordingly, all these means are prohibited, even though the executor does not have any intention to do the deed. If a person intends ultimately to arrive at the unlawful ends through *hiyal*, then it is a priority the means to be blocked and if the means itself is unlawful, then it therefore should be prohibited.<sup>565</sup>

### 4.8. *Hiyal* in Islamic Banking's Practice

#### 4.8.1 Bay' al-*ʿĪnah*

Islamic banking has various contracts, which have comprised of legal artifices' element. For the purpose of illustration, this study selects two famous contracts applied in the IBIs, namely *bay' al-ʿīnah* and *tawarrūq*. Literally, *al-ʿīnah* means an arrangement whereby a person sells an asset to another for deferred payment. Subsequently, the seller buys back the asset from the buyer for cash payment before the full amount of the deferred price is fully paid, in which the cash price is lesser than the de-

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<sup>562</sup> Abdul Kadir, *et al* (2011). "Parameter *Hiyal* dalam Kewangan Islam," 51-52.

<sup>563</sup> Kamali, *Principles of Islamic Jurisprudence*, 310.

<sup>564</sup> Ismail, "Legal Stratagems (*Hiyal*)," 111.

<sup>565</sup> Ibid. 112.

ferred price (see figure 4).<sup>566</sup> *Bay' al-ṭinah* is normally used in financing products, such as personal, house, credit card, and car financing. Many academic studies by either classical or contemporary scholars have been done on the *bay' al-ṭinah* contract. They had differing opinions about its permissibility and prohibition. Briefly, among the classical jurists, only the Shāfi'īs and the Zāhirīs permitted and legalized *bay' al-ṭinah*. Both schools contend that as long as the contract fulfills the requirements of sales, it would be accepted by Sharī'ah and they do not accept mere assumptions of any illegal intention or motive behind the contract, which has been discussed above. According to al-Nawāwī of the Shāfi'īs (d.1070), he said that it is a permissible contract given that it would not become customary practice and that the second sale is not stipulated in the first sale.<sup>567</sup> Some of the Shāfi'īs' jurists regard that *bay' al-ṭinah* is reprehensible (*makrūh*), despite admitting its legality.<sup>568</sup>

The structure of *bay' al-ṭinah* proposed by Imam al-Shafi'ī's can be described as follows: (a) Ali buys an item from Borhan in deferred payment and Borhan delivers the item to the buyer. Subsequently, Ali sells back the item to Borhan in cash, whereby its price may be lower or higher than the first sale transaction. (b) Ali buys an item from Borhan in deferred payment and Borhan delivers the item to the buyer. Then, Ali sells back the item to be in deferred payment, whereby its price may be lower or higher than the first sale transaction. (c) Ali buys an item from Borhan in deferred payment and Borhan delivers the item to the buyer. Then, Ali sells back the item to Borhan, but the compensation of the transaction is in the form-exchanged item (barter).<sup>569</sup>

On the other hand, the Mālikīs and the Ḥanbalīs rejected the validity of *bay' al-ṭinah* as they argue that the contract is merely a *ḥilah* to evade the prohibition of *ribā*.<sup>570</sup> Whereas, the Ḥanafīs assert that the contract is prohibited if the sale and buy-back are between the same two parties, since it would be similar to the fictitious transactions.<sup>571</sup>

<sup>566</sup> Ibn Manẓūr, *Lisān al-ʿArabī*, vol. 10, 141.

<sup>567</sup> Muḥyī al-Dīn Abū Zakariyyā Ibn Sharaf al-Nawāwī, *Rawḍah al-Ṭālibīn* (Bayrūt: Dār al-Kutub al-ʿIlmiyyah, n.d.) vol.3, 85-86; Engku Rabiah Adawiah Engku Ali "Bay' al-ṭinah and Tawarrūq: Mechanisms and Solutions," in *Essential Reading in Islamic Finance*, edited by Mohd Daud Bakar and Engku Rabiah Adawiyah binti Engku Ali (Kuala Lumpur, CERT, 2008), 136.

<sup>568</sup> Zuḥaylī, *Al-Fiqh al-Islāmī*, vol.4, 467-468; Engku Rabiah Adawiah, "Bay' al-ṭinah and Tawarrūq," 138.

<sup>569</sup> Mohamad, "Isu-Isu dalam Penggunaan Bai' al-ṭinah dan Tawarrūq," 70.

<sup>570</sup> Engku Rabiah Adawiah, "Bay' al-ṭinah and Tawarrūq," 138.

<sup>571</sup> Ibid.

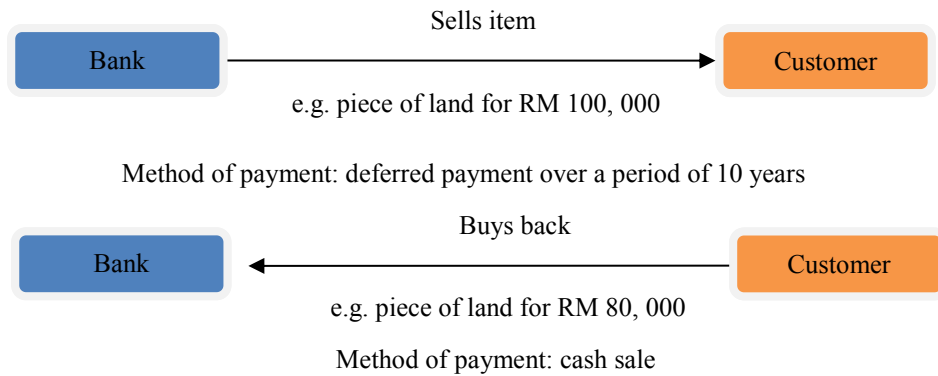


Figure 4: *Bay' al-Ṭinah* Structure<sup>572</sup>

Since *bay' al-ṭinah* is attributed to *hiyal* that aims to circumvent the prohibition of *ribā*, most Muslim jurists in the Middle East prohibited the practice of the contract. Therefore, there is no further discussion for validating it from the perspective of Sharī'ah from them.<sup>573</sup> However, this approach is different from the one adopted by the Malaysian Sharī'ah authority and jurists. For example, the SACBNM has endorsed the practice of the contract in the IFIs. The SACBNM has gradually resolved the problem of *bay' al-ṭinah* in different stages, where five resolutions have been made. The first resolution made, as a blanket approval was dated on 8 July 1997, where the council resolved that *bay' al-ṭinah* is permissible to be employed in issuance of Negotiable Islamic Debt Certificate (NIDC). In the second resolution of using *bay' al-ṭinah* in Islamic money market, the council stated that the practice of the contract should follow the methods used by al-Imām al-Shāfi'ī that there is no *ribāwī* item involved. However, the council did not elaborate in detail the method proposed by al-Imam al-Shāfi'īs. The third resolution dated on 10 April 2000 and 30 January 2002, the council resolved that sale and buy back contract on different dates is permissible and it is not a form of *bay' al-ṭinah*. Next resolution is more stringent, where the council stipulates that the application of the contract must observe the following conditions. It must consist of two clear and separate contracts; a purchase, and a sale contract. Furthermore, there is no stipulation is assigned to repurchase the asset. Other condition is that sale and buy-back concluded must be settled at different times. Next condition is that the sequence of each contract is correct, whereby; the first sale contract shall be completely executed

<sup>572</sup> Adopted from Engku Ali "Bay' al-Ṭinah and Tawarrūq," 133-165.

<sup>573</sup> Wizārat al-Awqāf wa al-Shu'ūn al-Islāmīyah, *al-Mawsū'ah al-Fiqhīyah*, vol. 14, 147; Mohamad, "Isu-Isu dalam Penggunaan Bai'al-Ṭinah dan Tawarrūq," 70



before the conclusion of the second sale contract. Finally, the transfer of ownership of the asset and a valid possession of the asset must be in accordance with the Sharī'ah and customary practices of business. Final resolution, which was dated on the same day, is only an attestation of the council concerning the stipulation to repurchase the asset that would render the contract as void.<sup>574</sup>

The main reason of the prohibition *bay' al-ṭinah* among majority of Muslim jurists and Sharī'ah authorities is the intention of contracting parties to circumvent the prohibition of *ribā*. They argue that the contract has violated the very basic purpose of sale transaction, where it is normally employed to exchange asset or commodity required by the buyer with money, and not an exchange of money with money. This can be evidenced through the contractual arrangement organized is clearly not to achieve the purpose of sale. However, SACBNM rejects this proposition and accepts the opinion of the Shāfi'īs, where the main justification of prohibiting any contract cannot be based on a mere presumption based on contractual form. Although majority scholars do not agree with the contract, Muslim jurists in Malaysia, such as Mohamad (2006) and Engku Ali (2006), argue that the contract is still required in Islamic banks, as it becomes a temporary transition for the banks to establish their products in the market.<sup>575</sup>

#### 4.8.2. Tawarrūq

*Tawarrūq* literally is derived from the Arabic term "*al- warīq*", which means silver money. *Tawarrūq* in the medieval time was used to denote seeking silver money (*dirhām*), whilst nowadays; it is employed for seeking paper money. *Tawarrūq* is seen as an alternative instrument for *bay' al-ṭinah*, which has been used for personal financing and liquidity management for Islamic bank. In practice of Islamic banking, *tawarrūq* is a form of sale in generating liquidity (cash) provided by IBIs to the customer that requires liquidity or cash in hand, which involves three parties rather than two parties in *bay' al-ṭinah* transaction. This transaction is performed, firstly by the financier, i.e. Islamic bank, sells an item to the customer with deferred payment mode. Then, the

<sup>574</sup> However, the main drawback of the resolution is the council does not address the external forces or external agreement, such as *wa'd* and *ṭawāṭu'* (pre-agreement), which are able to serve the same purpose of the internal force of stipulation. Bank Negara Malaysia, *Sharī'ah Resolutions*, 69-114.

<sup>575</sup> See the discussion in Mohamad, "Isu-Isu dalam Penggunaan Bai'al- Ṭinah dan Tawarrūq," 70; Engku Ali "Bay' al- Ṭinah and Tawarrūq," 133-165.

item is sold again by the customer to another third party under the basis of *bay' al-waḍī'ah* (selling at a price lower than the first purchase) to generate cash for him. It is stipulated, that the third party involved must not have any legal relationship to the original seller.<sup>576</sup> Typically, this transaction is made when someone is in a need of money to meet his personal desire and to avoid the practice of usury.

There are two forms of *tawarrūq* as implied by the Muslim jurists operating in the industry. However, the term of *tawarrūq* implies various terms. These include *al-tawarrūq al-fardī* (*tawarrūq* on individual basis) or *al-tawarrūq al-fiqhī* (juristic *tawarrūq*) or *al-tawarrūq al-haqiqī* (genuine *tawarrūq*). Another classification is *al-tawarrūq al-munazzam* (organized *tawarrūq*) or *al-tawarrūq al-maṣrifī* (banking *tawarrūq*).<sup>577</sup> The *al-tawarrūq al-fiqhī* or *al-tawarrūq al-haqiqī* is the purchase of a commodity possessed and owned by the seller for a delayed payment, whereupon the buyer (*al-mutawarrīq*) will resell the commodity for cash to a third party, other than the original seller, in order to acquire cash (*al-warīq*). In the first situation, the first buyer buys an item in installments from the first seller and sells it to a third party for cash at a price lower than the purchase price in installments. In this position, the third party involved has no connection with the first seller, where it is stipulated in the Sharī'ah that he cannot be associated of any means to the third party, directly or obliquely, if the buyer would sell the purchased item to him. On the other hand, *tawarrūq al-munazzam* is different from the genuine *tawarrūq*, where the third party is arranged by the seller. It seems that in this arrangement, the seller is deliberately attempted to ease the buyer to sell the commodity for cash, but in actual sense, both parties arrange a circumvention of *ribā*. In this regard, most Muslim jurists, theoretically agreed and concurred with the permissibility of the genuine *tawarrūq*, whereby the organized *tawarrūq* is disputed.<sup>578</sup>

Currently, most *tawarrūq* products developed and practiced in Islamic banking serve the purpose of facilitating liquidity management and credit financing required by the Islamic banks or individuals. Liquidity facility in the context of the banks is done through inter-bank placement between the Islamic banks that have surplus with the oth-

<sup>576</sup> Wizārat al-Awqāf wa al-Shu'ūn al-Islāmīyah, *al-Mawsū'ah al-Fiqhīyah*, vol. 14, 147.

<sup>577</sup> Some authors have distinguished between organized *Tawarrūq* and banking *Tawarrūq*. However, from the author's point of view, both mechanisms are the same, as at the end of the deal, *al-mutawarrīq* (the buyer of the item) finally will sell the item purchased to the third party, which is prearranged by the first seller. See Bouheraoua, "Tawarrūq in The Banking System" and Rafe Haneef, "Is the Ban Organised *Tawarrūq* the tip of the Iceberg?" 1-33 (ISRA Research Paper, No.2/2009, International Sharī'ah Research Academy, 2009)

<sup>578</sup> Ibid.

er banks that have deficit of funds. Both banks, for example, Bank A with surplus of fund and Bank B with shortfall of fund, would negotiate the general terms before any *tawarrūq* is executed. Prior to the transaction, Bank A buys a specific commodity, such as palm oil, from supplier A. The bank then sells to the Bank B on a *murābahah* basis and the method of payment is based on deferred payment. Bank B would accept the commodity and then sells it again to Supplier B on the spot arrangement. Whilst for the liquidity to consumers and clients, it is done on a similar basis, where at the end of the transaction, the customer will get cash in hand. With respect to credit financing to the individual, the method of structuring the financing is similar to the above framework (see figure 4).

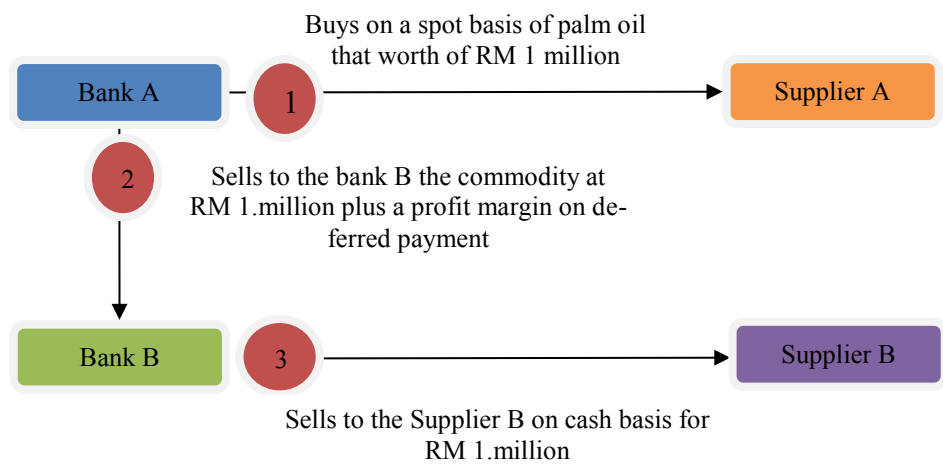


Figure 4: *Tawarrūq* Structure

Most classical jurists agreed on the permissibility of genuine *tawarrūq* transaction, supposing that there is no connection or stipulation between the three parties involved.<sup>579</sup> The issue of *tawarrūq* has attracted further discussions among Muslim scholars especially in the Middle East, such as Prof. Dr. Wahbah al-Zuhaylī, since the contract is not clearly prohibited among classical and contemporary jurists.<sup>580</sup> Classical jurists such as ‘Umar Ibn Abd Aziz and Muḥammad al-Shaybānī opined to discourage the practice of *tawarrūq*, whereas Ibn Taymīyah (d.1328) and Ibn Qayyim (d.1350) disallow its practice as it is similar to the legal artifice of *bay‘ al-‘īnah*.<sup>581</sup> Meanwhile,

<sup>579</sup> This study will not discuss in detail on the classical opinions on *Tawarrūq*, for further reading, one may refer to the writing of Wahbah al-Zuhaylī, “*Tawarrūq*, Its Essence and Its Types Mainstream *Tawarrūq* and Organized *Tawarrūq*,” (paper presented at Islamic *Fiqh* Academy conference of 19<sup>th</sup>, Sharjah, United Arab Emirates, 26-30 April 2009), accessed on 29 Nov. 2012, [www.isra.my](http://www.isra.my).

<sup>580</sup> Ibid.

<sup>581</sup> Engku Rabiah Adawiah, “Bay‘ al-‘īnah and *Tawarrūq*,” 140.

other contemporary scholars, such as Shyakh Muḥammad Taqi Usmani, Chairman of the AAOIFI, claimed that organized *tawarrūq* is a legal trick to generate cash through the camouflage of *ribā*. The Muslim jurists suspect that both contracting parties; the first seller and second buyer, have a pre-agreement and collusion to arrange the whole structure. This is similar to arrange financing facility with interest charged, but in the way of sale transaction. The main activity of Islamic economics and this activity, if it is expanded then it will hamper the progress of Islamic economics, as it will restrict and narrow the economic activities that Islamic economics aims at. The alternative contracts of *tawarrūq*, according to his opinion are *mushārah* and *muḍārabah*, which encourage the participative economic activities and fair distribution of wealth among people.<sup>582</sup> However, he failed to remember that most *tawarrūq* contracts are structured to facilitate personal requirements, such as paying debt, education, car, or liquidity management that are not related to business of partnership.

In the same vein, Siddiqi (2007) generally claimed that organized *tawarrūq* as realizing more corruption (*mafsadah*) rather than benefit (*maṣlahah*). One of them is that the product may create debt-proliferation. This contract among others leads to the creation of debt, which is likely to go on increasing and will cause in an exchange of money now with more money in the future. It is regarded as unfair in view of the risk and the uncertainty involved, which leads to gambling and speculation through debt creation. Furthermore, it also causes inequity in the distribution of income and wealth, and contributes to raising anxiety levels and the destruction of the environment by consolidating debt financing. He also argues that *tawarrūq* may be beneficial on an individual level but if it were practiced on a large scale, it would cause in the multiplication of debt in the society, which would result in a macroeconomic uncertainty.<sup>583</sup>

Khan (2009) contends that the commodities engaged in the transaction do not move around or are transferred from one hand to another hand. This is because it is being prepared through implicit ‘netting arrangements’ by the first seller and the second buyer (the third party). What happens in reality is that at any point of time, the commodities’ brokers own a quantity of commodities, e.g. metal, in which they will use and

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<sup>582</sup> Muḥammad Taqi Usmani, “Verdicts on at- *Tawarrūq* and its Banking Applications,” (paper presented at Islamic *Fiqh* Academy conference of 19<sup>th</sup>, Sharjah, United Arab Emirates, 26-30 April 2009), accessed on 29 Nov. 2012, [www.isra.my](http://www.isra.my).

<sup>583</sup> Muḥammad Nejatullah Siddiqi, “Economic of *Tawarrūq* How its Mafasid overwhelm the Masalih,” (paper presented at the *Tawarrūq* Seminar organised by the Harvard Islamic Finance Programme, at London School of Economics, London, UK on 1 February 2007)

reuse the same commodities at many times during the same day, as the subject matter of the transaction in numerous consecutive sales. For example, a broker holds 100 tons in his warehouse, that are valued at say Euro 100 million and he conducts *tawarrūq* transactions amounting to any multiple of that, for example Euro 10 or Euro 50 million or more. Throughout the whole processes, the *tawarrūq*'s commodities do not shift even an inch from the original position, as the commodities are not meant for the delivery to the parties concerned, i.e. the first and second buyer. In this case, he likens this transaction to the fractional reserve banking in conventional banks. Consequently, in truth, the physical commodities that should be transferred from the first seller to the first and second buyer are not materialized.<sup>584</sup>

The IFAOIC in its 19<sup>th</sup> meeting held between 26-30 April 2009, banned *tawarrūq* that has features of organized structure.<sup>585</sup> The academy held that organized *tawarrūq* is similar to individual *tawarrūq* in terms of the nature of selling and purchasing of the object. However, it is different in terms of the process engaged in the whole transaction, where, the first seller prearranges with the third party involved. The seller or financier acts, as an agent to the first buyer to sell the item to the third party (second buyer).<sup>586</sup> The effective cause ( *'illah*) provided by IFAOIC was that the contractual arrangement is made simultaneously between the financier and the *mustawriq* (the seeker of liquidity), either it is executed, explicit or implicitly or based on common practice in exchange for a financial obligation, is a circumvention of *ribā*.<sup>587</sup> IFAOIC considers this type of the transaction as deception in order to obtain quick cash from the arrangement, which constitutes the element of *ribā*. It is a synthetic arrangement to justify the transaction, in which the real purpose is to exchange money now for more money later. Based on these legal reasoning, it could be observed that the IFAOIC seems to take into account the intention or motive of the financier, i.e. Islamic bank, which is made clearly known that the contract's goal is to provide loan facility with interest charged, but in the form of sale transaction.

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<sup>584</sup> Salman H. Khan, "Why *Tawarrūq* Needs to Go: AAOIFI and the OIC Fiqh Academy: Divergence or agreement," *Islamic Finance News*, vol. 6, issues 35, 4<sup>th</sup> September 2009, 17-22.

<sup>585</sup> The Islamic *Fiqh* Academy of OIC is a currently well-known institution in contemporary Islamic law, which gathers almost expert jurists of Islamic law in the world to give various legal opinions concerning the civil matters of Muslims. For further information, see Islamic Fiqh Academy, accessed 29 Nov. 2012, <http://www.fiqhacademy.org.sa/>.

<sup>586</sup> Ibid.

<sup>587</sup> See resolution on *Tawarrūq* by Islamic Fiqh Academy of Organization of the Islamic Conference, accessed on 27 Nov. 2012, [www.isra.my](http://www.isra.my).

However, previously, there were other resolutions made by less prominent *fatāwā* institution, the Islamic *Fiqh* Assembly of Muslim World League (IFAMWL) based in Mekkah, in its two sessions. In the first resolution issued at the 15<sup>th</sup> meeting held on October 31, 1998, the IFAMWL admitted *tawarrūq* without reservations.<sup>588</sup> As the *tawarrūq* was practiced widely in the Gulf countries, the IFAMWL issued and revised the former resolution in its 17<sup>th</sup> meeting held December 13-17, 2003 that divided *tawarrūq* into two types; *al-tawarrūq al-haqīqī* (genuine *tawarrūq*) and *al-tawarrūq al-munazzam* (organized *tawarrūq*). The IFAMWL permitted the former while it prohibited the latter in Islamic financial transaction. The IFAMWL has given the reason for the prohibition because the process of transferring of the good's title by the financiers to the customer is ambiguous and vague, where there is no indication that the financiers are willing to transfer the title to the new owner, i.e. customer.<sup>589</sup>

From the three resolutions mentioned above, both institutions have agreed that classical *tawarrūq* contract is permissible, whilst organized *tawarrūq* is impermissible. The AAOIFI, another Islamic institution of legal *response*, which is currently based in Manama, Bahrain, has also provided Sharī'ah Standard, No. 30 to deal with the issues of *tawarrūq*. Among the requirements needed for practitioners to comply with in order to make it valid in the Sharī'ah, are the following. First, the bank or its agent should not sell the commodity on the customer's behalf if the customer initially bought that commodity from the bank; neither should the bank arrange a proxy third party to sell this commodity. Second, instead, the client should sell the commodity either himself or through his own agent. At the most, the bank should provide the client with the information needed to sell the commodity.<sup>590</sup> These stringent requirements are provided for avoiding and preventing the contracting parties in manipulating the transactions to camouflage the prohibition of *ribā*.

Notwithstanding, the SACBNM still allows the practice of *tawarrūq* in Malaysia. In the five resolutions made by the council, it did not address specifically the issue of organized *tawarrūq*, which has been ardently debated by scholars at the international

<sup>588</sup> See the first resolution on *Tawarrūq*, the Islamic *Fiqh* Assembly of Muslim World League on 4<sup>th</sup> September 1998, accessed on 27<sup>th</sup> Nov. 2012, <http://www.themwl.org/Fatwa/default.aspx?d=1&cid=145&l=AR&cid=10>.

<sup>589</sup> See second resolution on *tawarrūq* on 17<sup>th</sup> December 2003, the Islamic *Fiqh* Assembly of Muslim World League, "Resolution on *Tawarrūq*," accessed on 27 Nov. 2012, <http://www.themwl.org/Fatwa/default.aspx?d=1&cid=155&l=AR&cid=10>.

<sup>590</sup> AAOIFI, *Al-Ma'āyir al-Shar'iyyah*, 490-497.

level. In the latest resolution dated on 30 July 2008, the council resolved a product structure of commodity *murābahah* house (CMH), known as *sūq al-sila'*, as permissible given that the traded crude palm oil shall be identifiable and precisely determinable in terms of its location, quantity and quality in order to meet the features of a real transaction. It is also '*recommended*' that the transaction shall be executed randomly (unspecified or has not been predetermined or pre-arranged). It aims to ensure that the transacted asset is not to be resold to the original supplier. It is recommended that the transaction be made randomly in order to better meet the original features of *tawarrūq*. The term, 'recommendation' established in the resolution shows that the council does not so strictly regulate the issue of organized *tawarrūq* which indicates, on the other hand that it still allows the organized arrangement in the transaction of CMH.<sup>591</sup>

Nonetheless, the opinion of the above scholars was rejected by Hasan (2009), a Sharī'ah committee for SACBNM and Sharī'ah Advisory Council of Security Commission. He argues that *tawarrūq* is still desirable in the Islamic financial industry, because there is no viable alternative to replace the contract. What is required is to strengthen and improve the structure of the arrangement rather than prohibiting it without proposing any feasible alternatives. The contract is prohibited due to several violations and if it is properly fixed, executed, and fulfilled, in accordance to the requirements stated in the AAOIFI's standards, then the contract should not be prohibited. He furthermore suggests that some indispensable 'principles' are required; these are briefly mentioned as follows. First, the commodities used must be fitting as an underlying asset to meet the necessary requirements of a valid subject matter of a sale contract. Second is to allow Sharī'ah audit to examine operation of commodities used redundantly in the transaction. Third, the parties must conclude the contract separately in order to avoid the prohibition of two sales in a single sale. Finally, the seller is able to deliver the commodities if the parties concerned make such a request, in order to prove that the genuine economic transaction has transpired.<sup>592</sup>

In this respect, it is also observed that Hasan (2009) only sees the contractual form of the contract and he fails to observe the real intention of the contracting parties that arrange the contract. The recommendations suggested by him are only to improve the appearance of the *tawarrūq* and not the essence of the prohibition. The IIFAIOC

<sup>591</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 100.

<sup>592</sup> Aznan Hasan, "Why *Tawarrūq* Needs to Stay: Strengthen the practice, rather than prohibiting it," *Islamic Finance News*, vol.7. issue 36, 18<sup>th</sup> September 2009, 16-18.

and the AAOIFI, in this case do not prohibit classical *tawarrūq* that contracting parties separately conclude. This is not similar to organized *tawarrūq* where the first seller, i.e. Islamic bank already arranges each transaction. The contract in entirety resembles a *ribā* transaction, thus the two institutions opposed it. Furthermore, the suggestion that the commodities used must be suitable and to be delivered is inadequate, as the commodities used only perform a cosmetic arrangement and each party involved does not have any intention and plan to own the ‘commodities’. In addition, most of the trading of commodities is controlled by big commodities exchanges such as London Metal Exchange and The Chicago Mercantile Exchange, which do not have any Sharī‘ah council to monitor their operations of the exchange and all of the exchanges, are conducted through conventional procedures. Thus, if the Sharī‘ah members wish to conduct Sharī‘ah audit, surely the brokers and the exchanges would refuse, as there is no association with their operation, and especially as they operate under different jurisdiction, i.e. conventional legal framework. Hence, as asserted by Khan (2009), the intrinsic message of both *fatāwā* institutions is “either do it properly (as required in the AAOIFI’s standards that is classical *tawarrūq*) or don’t do it all” is a proper standpoint and a strong memorandum for the prohibition.<sup>593</sup>

Another supporter of organized *tawarrūq*, Rafe Haneef (2009), CEO of HSBC Amanah (Malaysia), claims that organized *tawarrūq* has been used effectively to satisfy a variety of social needs ranging from financing educational fees, medical expenses, legal costs and various other genuine needs. If it is prohibited, customers in these situations will unfortunately end up taking a conventional facility since other options are simply not feasible. He furthermore questioned that why only *tawarrūq* and why not other contemporary products, such as *bay‘ al-murābahah lil-āmir bi-al-shirā’*, *ijārah muntahiyah bi tamlīk*, contemporary *shukūk muḍārabah*, *mushārah* or *wakālah*, which share similar features, are not prohibited. This is because he implies that the structure of organized *tawarrūq* is similar to other contemporary contracts and the proponents of the prohibition have applied different standard to *tawarrūq*. This is specifically in reference to the issue of appointing *wakālah* or an agent to organize the transaction. He questioned why it is prohibited for the *mutawarrīq* (customer) to appoint the *muwarriq* (the first seller) to sell the commodity to the third party, albeit it is permitted in *bay‘ al-murābahah lil-āmir bi-al-shirā’* (cost markup sales for a purchase orderer) and *ijārah*

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<sup>593</sup> Khan, “Why *Tawarrūq* Needs to Go,” 18.



*muntahiyah bi tamlik* (hire purchase). This is due to the same standard, i.e. appointing an agent, is also applied to organized *tawarruq*. He also contended that the prohibition of organized *tawarruq* is because the disappointment of the proponents of the prohibition on the Islamic finance industry and prohibiting organized *tawarruq* would give a strong message to the industry so that it has to transform from conventional platform to the truly Islamic economics spirit. Moreover, he realized that the difference between the contemporary contracts and organized *tawarruq* is that the customer of the former contracts requires the goods and assets financed to be involved in the transaction. However, in the transaction of organized *tawarruq*, the customer merely necessitates ‘artificial assets’ as a prop and underlying asset, which appears as synthetic contract or prohibited *hiyal* to the proponents that results to *riba*.<sup>594</sup>

#### 4.9. Conclusion

Generally, most Muslim jurists accept *hiyal* in Sharī‘ah on the ground that the practice is not explicitly contrary to the Sharī‘ah principles – it does not make illegal matters permissible. However, this proposition is too general and creates a tension between, on one hand, the Islamic value in religion of Islam that promotes the rule of law and on the other hand, creates circumvented means to evade that same law. From the arguments above, it is established that *hiyal* are only permitted and restricted to situations of difficulty and hardship exposed by a Muslim in order for him/her to practice his daily life as a Muslim.

Nonetheless, in the context of product development of Islamic banking, it seems that the practice of *hiyal* has been unduly employed in many situations. This creates some perception that Islamic banking is not Islamic as propounded by the founders of Islamic banks, but as “bank of *hiyal*” as there are many *hiyal* instruments being employed to develop their product and services. It seems that the use of *hiyal* in Islamic banking is a compromise between the requirements of the financial market and the Sharī‘ah, as the former is based on interest while the latter prohibit it. This proposition on the other hand gave some idea to the practice of Islamic commercial transactions – it seems that the contractual conformity has prevailed rather than the economic efficiency. However, this statement remains a presumption, and it is too early to draw any con-

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<sup>594</sup> Haneef, “Is the Ban Organised *Tawarruq*,” 1-33.

clusions without making any examination to the real practice of product development in Islamic banking that will be discussed shortly in next chapter.

It is also can be concluded that the idea of *hiyal* is an unconvincing method for product development of Islamic banking, since it cannot uphold the objectives of Shari'ah and Islamic economics. The process of product development in Islamic banking is seen as a cosmetic innovation, whereby the features and characteristics of conventional products still exist. By persistently using this method, Islamic banking's product development is observed as a failure in banking sector to create anything new and to give an alternative financing to customers.

## CHAPTER 5: ISLAMIC BANKING PRODUCTS: CASE STUDIES

### 5.1. Introduction

This chapter analyzes the features and Sharī'ah issues involving selected Islamic banking products. Besides, it also aims to integrate the theoretical assumptions and argumentations with the practical application of developing Islamic banking products. The case studies provided are not expected to generalize the process and structure of Islamic banking products, since each product offered in the Malaysian Islamic banks has different features and contracts. In that case, the products shall be examined on a case-by-case study. The case study is stated with the introduction of the product from the perspective of Sharī'ah, then it is followed with the information of the product offered by the bank selected, and finally it is followed with the analysis of Sharī'ah issues.

### 5.2. Case I: Islamic Credit Card Facility

#### 5.2.1. The concept of Islamic credit card

Credit card is a payment card issued to users as a system of payment that allows a cardholder to pay goods, products, and services on credit. Generally, credit card is known as plastic money to facilitate the cardholder to pay for any purchases made on credit. Most of the time, the card is issued and offered, by banks, retail stores, saving and loan institutions and other business entities<sup>595</sup>. The first credit card was introduced in 1920 in the United States, which aimed to sell fuel for a growing number of automobile owners. It was Ralph Schneider and Frank McNamara; the founders of Diners Club in 1950s that had made credit cards popular in the market by introducing the first general purpose charge card that can be used to pay for services and items. Since then, credit cards expanded to serve as a payment system to pay for various products and services<sup>596</sup>. According to Zywicki (2000), the primary usage of credit cards today is as a transactional medium, not as a source of credit. Over half and probably as much as 68% of credit card, users should be considered convenience users, who use credit cards

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<sup>595</sup> Investorswords, "Credit Card," accessed on 22 January 2013, [http://www.investorwords.com/1199/credit\\_card.html](http://www.investorwords.com/1199/credit_card.html).

<sup>596</sup> Encyclopedia Britannica, "Credit Card," accessed 20 January 2013, <http://www.britannica.com/EBchecked/topic/142321/credit-card>.

primarily as a transactional medium and who pay off their balances in full each month. This is due to, first is credit cards enable individuals to maximize their cash balances, thereby allowing them to shift their assets into higher-return investments. Second, there is an explosion in consumer demand for credit card use, largely as the result of the convenience of using credit cards as a mechanism for conducting transactions<sup>597</sup>.

The credit card is a variable repayment card, which offers a line of credit to the cardholder that can spend up to a pre-arranged ceiling level. The extended credit must be settled within a given grace period, otherwise interest will be charged on the outstanding balance. The cardholder is also convenient to carry credits cards rather than cash, since they are thin, which easily can be brought in a wallet, and acceptable worldwide<sup>598</sup>. The cardholder is given a limited credit facility by the issuer and the payment of the outstanding amounts can be rollover within the credit limit and credit period determined by the issuer, if the cardholder is unable to pay the full amount owed. Furthermore, the cardholder is able to withdraw cash without charging any interest, within the approved limit and for a given credit period, during which the amount due should be paid. However, once the cardholder delays the payment, the outstanding amount will be charged with interest for the duration of the credit. On the other hand, the issuer of the card is obliged to pay the party accepting the card, i.e. the merchant, the amount owed by the cardholder within a specified transaction credit limit. The relationship between the issuer and merchant is independent. Meanwhile, the nexus between the issuer and the cardholder is dependent, where the issuer will reimburse the merchant for any payments made by the cardholder from the account that he/she opened with the issuer. Besides, the issuer also may demand directly the payment of the credit from the cardholder through monthly statement.

Conventional credit cards in Malaysia are relatively new, where the first credit card was only introduced in the 1970s.<sup>599</sup> Until January 2013, there were 26 financial institutions issuing credit cards including four non-bank financial institutions<sup>600</sup>. In the early

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<sup>597</sup> Todd J. Zywicki, "The Economics of Credit Cards," 1-125 (George Mason Law and Economics Working Paper no. 00-22, George Mason University, 2000), accessed on 28 January 2013, [http://www.law.gmu.edu/assets/files/publications/working\\_papers/00-22.pdf](http://www.law.gmu.edu/assets/files/publications/working_papers/00-22.pdf).

<sup>598</sup> Dean Paxson and Douglas Wood, *The Blackwell Encyclopedia of Management and Encyclopedic Dictionaries, The Blackwell Encyclopedic Dictionary of Finance* (US: John Wiley and Sons, 1998), 52-53.

<sup>599</sup> Nasimah Husein, "An Analysis of Attitudes to Islamic and Conventional Credit Cards in Malaysia Perspectives on Selection Criteria and Impact Analysis," (PhD diss., University of Durham, 2011), 45.

<sup>600</sup> Bank Negara Malaysia, "List of Regulatees issuing credit card," accessed on 22 January 2013, [http://www.bnm.gov.my/index.php?ch=ps&pg=ps\\_regulatees#Credit](http://www.bnm.gov.my/index.php?ch=ps&pg=ps_regulatees#Credit).

phases, it was dominantly used for large ticket transactions and mainly accessible to the rich people. However, starting in the 1990s, they became more reachable to a wider group and any person could have the card on the condition his income level was over RM 24, 000 per year and able to prove his active employment for at least three months. However, the requirement of income was reduced to RM18, 000 in 1997 in response to the Asian financial crisis aimed to ease the problem of liquidity and to increase spending habit to buy domestic products and services among Malaysians<sup>601</sup>. This effort was taken in order to boost back the domestic industry, particularly manufacturing and small-scale and medium industries. This requirement remained in effect until 18 March 2010, when the amount was raised back to the former amount of RM24, 000 by the government.<sup>602</sup> This was purposely done to tighten the consumer habit and to curb the acceleration of debt among Malaysians, who are unable to pay the liability.<sup>603</sup>

Furthermore, there was another restriction introduced by the Malaysian government regarding the number of credit cards. Cardholders whose annual incomes are equivalent to or below RM36, 000, can hold at the most only two credit cards from different issuers/financial institutions. Furthermore, the credit limit approved should not exceed more than twice of the cardholders' monthly income.<sup>604</sup> The eligible applicants must be above 21 years of age, while those who apply for a supplementary card, they must be at least 18 years old. Besides, in an effort to control credit card's debt among Malaysians, the government has introduced a credit card service tax, which became effective beginning from 1 July 2010. The levy of the service tax is RM50 for every principal card and RM25 for every supplementary card.<sup>605</sup>

In a typical credit card transaction, four parties involved, namely the credit cardholder, the issuer, the merchants, i.e. sellers or vendors, and the clearinghouses, such as Mastercard and Visa that process the merchants' claims, to transfer the pay-

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<sup>601</sup> This effort was taken in order is intended to boost back the domestic industry, particularly manufacturing and small-scale industry and medium. Y. J. Loke, "Determinants of Merchant Participation in Credit Card Payment Schemes," *Review of Network Economics* 6, no. 4 (2007): 474-494.

<sup>602</sup> Bank Negara Malaysia, "New Guidelines on Credit Card Application," accessed 22 January 2013, [www.bnm.gov.my](http://www.bnm.gov.my).

<sup>603</sup> The SUNDAILY, "BNM new rules will have little impact on banks, say analysts," accessed on 22 January 2013, <http://www.thesundaily.my/news/216115>.

<sup>604</sup> Ibid.

<sup>605</sup> Muhmamad Najib Abdul-Razak, "The 2010 Budget Speech," accessed on 22 January 2013, <http://www.1malaysia.com.my/speeches/dewan-rakyat>; CIMB Bank, "Credit Card's Service Tax Information," accessed on 22 January 2013, <http://cb.cimbislamic.com/index.php?rp=card+gst>; Nasimah Hussein, "An Analysis of Attitudes to Islamic and Conventional Credit Cards in Malaysia Perspectives on Selection Criteria and Impact Analysis," (PhD diss., University of Durham, 2011), 45.

ments made by the issuer. Meanwhile, the nexus between cardholder and issuer in conventional credit card is lender and debtor. In this respect, as a lender, the issuer provides credit limit to the cardholder, i.e. debtor and offers an option, either to settle the full amount of the debt or pays only the minimum amount and revolves the outstanding balance. If the cardholder chooses the latter, the issuer will charge interest as the compensation for the delay.<sup>606</sup>

The issuer of credit cards makes profit in three ways. First, an annual fee charged to the cardholders makes profit. Although, as a marketing strategy to attract cardholders, the fee may sometimes be waived off for the first year. The cardholders can use the card up to the credit limit approved by the issuer. Second, discounts taken by the issuer from merchant's invoices increase profit. When the merchant sells an item for example, costing RM100 to a cardholder, the merchant only obtains RM 98 from the bank, and the difference is taken by the bank, as a profit. Finally, the bank may take the profit through the interest charged on outstanding amount on a periodic basis after the expiry of the grace period, which is normally 33-45 days or a month, if the cardholder picks to rollover the outstanding balance that is due then the bank makes a profit. This is prohibited under the Sharī'ah, since it is equivalent to *ribā*, while the two methods are permitted due to they do not involve any elements of *ribā*.<sup>607</sup>

Conventional credit card is prohibited to Muslims, as it involves the interest payment. Since the modern style of life requires credit card and the market for it is encouraging, Islamic banks also have offered Islamic credit card based on different structure of conventional banks. They seek alternative and viable methods to formulate and structure credit card that would have similar features to conventional credit card in terms of its functions but complies with the Sharī'ah principles. In 1992, AmBank Islamic was the first bank issued the Islamic credit card, which was known as *al-Taslif* Islamic credit card. However, this credit card was unpopular among Malaysians, probably due to the Muslims' skepticism of its validity from the Sharī'ah perspective and the marketing strategy prepared by the bank was not successful. This lasted until 2002, when BIMB introduced its Islamic credit card and it became more popular among Mus-

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<sup>606</sup> Nurbek Kenjebaev, "Sharī'ah-Compliant Credit Cards an Analysis of Underlying Structures," *ISRA International Journal of Islamic Finance* 4, no. 1 (2012):129-149.

<sup>607</sup> Ibid.

lim cardholders.<sup>608</sup> Thereafter, many other Islamic banks followed the step, such as Maybank, CIMB, and RHB introducing Islamic credit card as part of their products.

Many structures of Islamic credit cards have been proposed by Islamic banks such as *bay' al-ṭinah* (sale and immediate buy back), *ijārah* (leasing), *tawarrūq* (tripartite sales), *ujrah* (fee), hybrid contracts of *ujrah* and *kafālah* (guarantee) as well as *murābahah* (sale with mark-up). From our observation until February 2015, as presented in table 1, eight Islamic banks in Malaysia have offered the Islamic credit card facility to the cardholders. However, only two contracts are widely utilized by Islamic banks, namely *tawarrūq* and *ujrah*. Other Islamic banks do not offer Islamic credit card, probably because of the difficulty faced in finding appropriate and viable structures that would be in line with the contractual principles of the Sharī'ah.<sup>609</sup>

| No. | Name of the Bank                      | Contracts                    |
|-----|---------------------------------------|------------------------------|
| 1.  | AmBank Islamic                        | <i>Ujrah</i>                 |
| 2.  | Bank Islam Malaysia Berhad            | <i>Tawarrūq</i>              |
| 3.  | Bank Kerjasama Rakyat Malaysia Berhad | <i>Tawarrūq</i>              |
| 4.  | Bank Simpanan Nasional                | <i>Ujrah</i>                 |
| 5.  | CIMB Islamic Bank Berhad              | <i>Ujrah</i>                 |
| 6.  | HSBC Amanah Berhad                    | <i>Ujrah</i>                 |
| 7.  | Maybank Islamic Berhad                | <i>Ujrah</i> and <i>Qard</i> |
| 8.  | RHB Islamic Bank Berhad               | <i>Ujrah</i>                 |

Table 2 : The Applied Contracts of Islamic Credit Card<sup>610</sup>

### 5.2.2. Sharī'ah rulings of Islamic credit card

Generally, Islamic credit card is permitted by most Sharī'ah boards, such as the AAOIFI, IIFAOIC, and SACBNM. The AAOIFI, for example, permits Islamic financial institutions to offer Islamic credit card, provided there is no interest imposed on the cardholders. Furthermore, the usage of the card does not contravene with the principles of the Sharī'ah, such as to purchase alcoholic beverages, pornographic materials or to

<sup>608</sup> M. M. Billah, "Islamic Credit Card in Practice," *Journal of Islamic Banking and Finance* 25 (October 2007): 35-42.

<sup>609</sup> See for example Mohamed Obaidulla, *Islamic Financial Services* (Saudi Arabia: Islamic Economics Research Center King Abdulaziz University, 2005), 105-106.

<sup>610</sup> The information is acquired from the website provided by each bank, as accurate on February 2015.

involve in gambling activities. The AAOIFI also allows the issuer of the Islamic credit card to have affiliations with international credit card organizations, such as MasterCard, Visa, or American Express, provided the issuer must avoid any elements of violations to the Sharī'ah principles. It also allows the issuer to pay fees charged by the organizations, but not to engage in any payment of interest, for example, in the case of increasing the service of credit, the bank also increases its charges based on the credit granted.<sup>611</sup>

In addition, AAOIFI also approves the issuer to charge a commission fee to the merchants on every purchasing made by the cardholders, at the purchase price of the items bought and services on the card, as well as membership, renewal, and replacement fees to the cardholder. Hence, this is pertinent to the concept of *ujrah* as charges that are imposed should be based on the services and not on the credit granted by the issuer of credit card. It is also permitted for the cardholder to purchase gold and silver provided the Islamic banks are able to pay the amount due to the merchants, i.e. the seller of the gold/silver without any delay in order to avoid the transaction falling into *ribā al-faḍl* (*ribā* of sale).<sup>612</sup> In the meantime, the cardholder is permitted to withdraw cash within the limit of the credit cardholder provided there is no involvement of interest. It is also permitted to impose a flat fee and not variable based on the withdrawal amount, as a charge imposed for the services rendered. The cardholder also should not use the facility to buy prohibited goods and that is not in line with the Sharī'ah principles.<sup>613</sup>

Meanwhile, the IIFAOIC (2000) also issued four resolutions regarding Islamic credit card. First, it is prohibited to issue a credit card that imposes usurious interest. Second, it is permissible to charge the cardholder specific fee at the time of issuing and renewal of the card and a commission on the goods or services purchased by the cardholder provided such goods are sold at the same price, either cash or credit. Third, it is permissible for the cardholder to withdraw cash, as long as it does not entail any usurious interest. It is allowed for the bank to charge the fixed fee for his actual services, which is not linked to the loan/debt amount. Finally, it is allowed to use a credit card to

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<sup>611</sup> AAOIFI, *al-Ma'āyir al-Shar'īyah*, 22-24.

<sup>612</sup> See the discussion on simple definition of *ribā al-faḍl* by Emad H.Khalil, "An overview of the Sharī'ah Prohibition of Ribā," in *Interest in Islamic Economics*, edited by Abdulkader Thomas (London: Routledge, 2006), 55-57.

<sup>613</sup> Ibid.



purchase gold, silver and currencies.<sup>614</sup> In addition, IIFAOIC (2004) also issued another resolution, which is related to unsecured credit card, where the academy emphasised the issuer of the card is required to observe strict Sharī'ah rulings and abstain from *ribā* element.<sup>615</sup>

The SACBNM (2010) in the same vein issued five resolutions concerning credit cards. First, the use of *bay' al-ṭinah* and *wadī'ah* (safe keeping) contracts as the structure, where the council approved the banks may use both contracts, as the underlying concepts.<sup>616</sup> Second, the SACBNM approved the use of *ujrah*, as a mechanism to be utilized in Islamic credit card, which is regarded as a consideration for the provision of actual benefits and privileges of services rendered by the banks. The banks are allowed to impose different amount of *ujrah* on various types of credit cards that offer different kind of services, benefits, and privileges as long as the charges imposed are not related to the element of *qard* (loan). Furthermore, the council also allowed the banks to impose on cardholder charges on the actual management cost, which must not be based on the credit granted but to the services rendered.<sup>617</sup> Third, the SACBNM (2010) also approved *takāful* (Islamic insurance) protection can be offered to the cardholder on a condition it is offered as *hibah* (reward) not part of *ujrah* paid to the bank. This is done because it is feared the transaction falls under interpretation of *ribā al-faḍl*, as cash in the form of *ujrah* is exchanged with cash at different value (as the compensation of *takāful* is also in the form of cash) is tantamount to *ribā*.<sup>618</sup> Moreover, the cardholder is not a direct participant in *takāful* scheme instead; the payment of *ujrah* is imposed on the cardholders as a consideration for the services rendered and not for the *takāful* coverage.<sup>619</sup> Fourth, it is not allowed for the issuer to offer cash back rebate to credit card's annual fee if the cardholder has utilized the card at least twice a month. However, cash back rebate can be offered in the form of *hibah* without any imposition of *ujrah*. The condition of utilising the credit card twice a month is observed as *ribā* to *ujrah* paid, which an exchange of cash with cash at different value. However, if cash back rebate is given as *hibah*, then the rule is different as *hibah* is made by a unilateral party that vol-

<sup>614</sup> International Islamic Fiqh Academy, *Resolutions and Recommendations*, 134, 171, 221, 249.

<sup>615</sup> International Sharī'ah Research Academy for Islamic Finance (ISRA), "Resolution on Credit Cards (Resolution No. 139 (15/5) 2004, Issued by the International Council of Fiqh Academy," accessed 23 January 2013, [www.isra.my](http://www.isra.my).

<sup>616</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 148-154.

<sup>617</sup> Ibid.

<sup>618</sup> Ibid; Wizārat al-Awqāf wa al-Shu'ūn al-Islāmīyah, *al-Mawsū'ah al-Fiqhīyah*, vol. 22, 57.

<sup>619</sup> Ibid.

unteers to give the *hibah* without expecting any return or monetary compensation. Finally, the council also decided not to allow the Islamic credit card to be based on the combination of *wakālah*, *ujrah*, and *kafālah*. One of the reasons for the prohibition is the *ujrah* should be a fixed amount without being tied to a credit limit to avoid the element of *ribā*.<sup>620</sup>

Meanwhile, SACBNM (2010) also approved the contract of *kafālah bi al-ujr* as permissible to be used in Islamic finance based on the justification provided by Ḥammād (1997). He argued the contract is permissible on the ground of *maṣlaḥah* and public needs since it is difficult and impractical to obtain free-of-charge guarantee. Furthermore, the council explained the contract is similar to the concept of charging fee for someone's reputation and the treatment/medication of using Quranic verses. Both concepts seem have similarities in terms of the services provided by the guarantor in the arrangement of Islamic credit card.<sup>621</sup> According to Ḥammād (1997) three juristic opinions have been given on *kafālah bi al-ujr*. The first opinion views charging fee or commission to provide guarantee is illegal, by virtue of the nature of the contract as it is grouped under the charitable deeds. The second opinion regards charging a fee on *kafālah* is permissible as there are no verses in the Qur'ān and the Sunnah that prohibit such deed.<sup>622</sup> Finally, the third opinion views charging a fee is permissible on the condition the fee is returned to the guarantee in case the guarantor pays the debt and then demands reimbursement from the debtor to avoid any suspicion of *ribā*. Apart from charging a fee for the services, since the bank guarantees the payment's obligations of the cardholder, the bank may justify the fee charged, which may become part of the *ujrah*.<sup>623</sup> Furthermore, Ḥammād (1997) argued a contract of *tabarrū* (non-exchange contract) is permissible to be converted to a *mu'āwadah* (exchange contract) provided the contracting parties give the consent.<sup>624</sup> In this case, a guarantor deserves a good compensation since his commitment to the guaranteed person to settle his debt. This is

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<sup>620</sup> Ibid

<sup>621</sup> Ibid.

<sup>622</sup> Ḥammād, *al-'Uqūd al-Murakkabah*, 13; International Islamic Fiqh Academy, *Resolutions and Recommendations*, 134, 171, 221, 249; Islamic Fiqh Academy of OIC, "*Majallah Majma' al-Fiqh al-Islāmī*," 2 (2) (1986): 1146 – 1147.

<sup>623</sup> Mohammad Ali El-Gari, "Unsecured Instalment Credit Cards," *Majallah Majma' al-Fiqh al-Islāmī*, (Journal of the Islamic Fiqh Academy of the OIC) 15, no. 3 (2009): 95-112, accessed 31 January 2013, [www.isra.my](http://www.isra.my).

<sup>624</sup> Nazih Kamāl Ḥammād, "Madā jawaz akhz al-ujr 'ala al-kafālah fi al-fiqh al-Islāmī," *Journal of King Abdul Aziz University: Islamic Economics* 9 (1997): 95 -121; Mohd Azli and Mohd Noor, "Issuance of Islamic Credit Card in Malaysia: A Critical Analysis". 5-6.

equivalent to the conversion of *hibah al-thawab* (gift with reward) from *hibah* (gift). Similarly, a lending contract (*‘ariyyah*) associated with a consideration can be converted to *ijārah*, and *wakālah* associated with a consideration can be converted to *wakālah bi al-ujr*.<sup>625</sup>

In this respect, majority of Sharī‘ah scholars observes *kafālah* is *tabarru‘* (non-exchange contract), while *ujrah* is *mu‘āwadah* (exchange contract).<sup>626</sup> According to Zuhaylī (2013), when *ujrah* is combined with *kafalah*, the combination of two contracts is regarded as an exchange contract. He classified the contract under the *ju‘ālah* (reward) or *ijārah* contract. Under *ijārah*, it can be known as *ijārah ‘ala al-‘amal*, which is a fee is given due to the services provided.<sup>627</sup> According to Engku Ali (2008), when the guarantor charges a fee on an advancement of money or loan (*qard*), it is considered as *ribā*. This is due to every loan, which brings benefits to the creditor is considered *ribā*. The fee is deemed as the benefit or compensation given by the borrower to the creditor.<sup>628</sup> However, the guarantor may impose some fees if he/she has used some space to keep the item, which incurred some operational cost. Hence, the guarantor is allowed to charge the actual cost incurred, however he/she is still not allowed to consider it as a commercial or business transaction.<sup>629</sup>

Classical scholars, according to Noor and Azli (2011) such as Ibn ‘Ābidīn, Ibn Qudāmah, Ibn Dusūqī and al-Māwardī objected the contract of *kafālah* associated with fee.<sup>630</sup> In the same vein, contemporary scholars, such as Sallāmī (2000) and Ḍarīr (1999) refuted the contract of *kafālah bi al-ujr* is permitted in the Sharī‘ah. Sallami (2000) argued those contracts associated with considerations have different legal natures and consequences. To refute the arguments provided by Ḥammād (1997) regarding the status of *hibah al-thawab*, he contended the contract is not a real *hibah*, but a *mu‘āwadah* contract, which is a new contract and different to the concept of *tabarru‘*. Therefore, the analogy of *hibah al-thawab* to *kafālah bi al-ujr* is not applicable. Fur-

<sup>625</sup> Ḥammād, “Madā jawaz akhz al-ujr,” 95-121.

<sup>626</sup> Ibn Ḥajar al-‘Asqalānī, *Bulūgh al-Marām min Adillat al-Aḥkām* (al-Qāhirah: Maṭba‘ah al-Salafīyyah, 1928), 176.

<sup>627</sup> Abū Hassan Aḥmad ibn Aḥmad ibn Ja‘far al-Qudūrī al-Ḥanafī al-Baghdadi, *Mukhtaṣar al-Qudūrī fī al-Fiqh al-Ḥanafī* (Bayrūt: Dār al-Kutub al-Ilmi‘ah, 2004), 102; Hiroyuki Yan-agihashi, *A History of the Early Islamic Law of Property: Reconstructing the Legal Development 7th-9th Centuries* (Leiden: Brill, 1997), 40; Zuhaylī *Fiqh al-Islāmī wa Adil-latuh*, vol.4, 766; ‘Abd al-Sattār Abū Ghuddah, “Practical Application of al-Ijārah al-Mawsūfah fī al-Dhimmah (Forward Ijārah),” accessed on 23 January 2013, Accessed on 23 January 2013, <http://www.ifkr.isra.my>.

<sup>628</sup> Engku Ali “Bay‘ al-‘Īnah and Tawarrūq,” 133-165.

<sup>629</sup> Zuhaylī *Fiqh al-Islāmī wa Adil-latuh*, vol.4, 766.

<sup>630</sup> Mohd Azli and Mohd Noor, “Issuance of Islamic Credit Card in Malaysia: A Critical Analysis”. 5-6.

thermore, for *ijarah* converted from *‘āriyyah* associated with a consideration is regarded as a hire from the very beginning and not as a new contract. This is also applied to *wakālah bi al-ujr*, which is converted from *wakālah* contract should not be regarded as a conversion.<sup>631</sup> In this regard, Darir (1999) contended the conversion of the contracts from *tabarrū‘* to *mu‘āwadah* is actually the independent established and known contracts, which has been recognised by Shar‘iah and this is not applied to *kafālah bi al-ujr*. This is because the conversion a guarantee to a debt with fee is prohibited due it is similar to lending or giving a loan with charging fee, which is equivalent to *ribā*.<sup>632</sup>

### 5.2.3. The case of Maybank’s Islamic credit card

Maybank Islamic Berhad is an Islamic commercial bank that commenced its operations on 1 January 2008, and it is wholly owned by Maybank Group, the conventional bank and the largest banking group in Malaysia. Previously, it had offered Islamic banking products and services under Islamic banking scheme (IBS). Nowadays (January 2013), the bank has 14 dedicated branches and its products are co-located at 380 branches of Maybank group nationwide.<sup>633</sup> Maybank’s Islamic credit cards are part of consumer banking, where the bank offers five other different types of products, namely Maybank Islamic PETRONAS Ikhwan Visa Platinum Card-i, Maybank Islamic PETRONAS Ikhwan Visa Gold Card-i, Maybank Islamic Ikhwan American Express Platinum Card-i, Maybank Islamic Ikhwan American Express Gold Card-i, and Maybank Islamic Ikhwan Visa Infinite Card-i. Most of the products use the international leading credit cards associated; namely, Visa, Mastercard or American Express, which provide international recognized methods of payment and are structured under the concepts of *ujrah* and *qard*. Previously, Maybank’s Islamic credit cards operate under *bay‘ al-‘inah*, however on 24 December 2012, it changed to *ujrah* concept. The change is made to avoid the controversial issues surrounding the contract. In justification of the

<sup>631</sup> Muḥammad Mukhtār Sallamī, Comments on Nazīh Kamal Ḥammād’s paper Madā jawaz akhz al-ujr ‘ala al-kafālah fī al-fiqh al-Islāmī, *Journal of King Abdul al-Aziz: Islamic Economics* 12 (2000): 123-132.

<sup>632</sup> Al-Ṣadiq Muḥammad al-Amīn al-Ḍarīr, Comments on Nazīh Kamal Ḥammād’s paper Madā jawaz akhz al-ujr ‘ala al-kafālah fī al-fiqh al-Islāmī, *Journal of King Abdul al-Aziz: Islamic Economics* 11 (1999): 95-101; Mohd Azli and Mohd Noor, “Issuance of Islamic Credit Card in Malaysia: A Critical Analysis”. 5-6.

<sup>633</sup> Maybank Islamic Berhad, “Corporate Info,” accessed on 23 January 2013, <http://maybankislamic.com.my/info.html>.

substitution, the bank stated that the new Sharī'ah concept would incorporate better benefits by simplifying the process of card activation and increasing the card limit.<sup>634</sup>

In the product term sheets provided, it is stated the credit cards of the bank employ a single *ujrah* concept. However, in reality, they are a combination of multiple contracts comprising *ujrah*, *kafālah* and *qard*. *Ujrah* is used as an underlying contract for the bank to manage and maintain the services provided by the bank to the cardholders and to justify the charging of fees for the services provided. Meanwhile, *kafālah* is employed for the bank to provide a guarantee to the merchants on the payments and advancement of money. i.e. *qard* to the cardholder to purchase intended goods. Cardholders also are allowed to withdraw cash, which is considered as *qard* from the bank to the cardholders.<sup>635</sup>

From the five Islamic credit cards offered by the bank, this research has selected one card, as a case study. This card may represent other cards offered by the bank, as the structure and concept of Sharī'ah contracts applied are similar to other cards. Furthermore, this card is considered as a basic Islamic credit card in which ordinary cardholders can apply, whereas other four cards offered by the bank are tailored for specific cardholders and segmentations. The card has three different types offered, namely Gold, Platinum, and Infinite. The subscription of each card depends on the income and the assessment of the bank over the credit background of the cardholder. For the Gold and Platinum cardholder, the credit limit ranges from RM3, 000 onwards, subject to credit evaluation or not more than 2 times of the cardholder's monthly income if the income is RM 36,000 per annum or less. Meanwhile, for the Infinite cardholder, there is no restriction to the credit card limit.<sup>636</sup>

The flow of product can be explained as follows:

- (i) The client applies for the Islamic credit card and the bank examines his credit background, income and capability to pay back, before it determines the credit limit for the cardholder. The cardholder may use the card to the extent of the credit limit approved by the bank.

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<sup>634</sup> However, the conversion from the former to the latter also created many issues, which will be discussed shortly. See Maybank Islamic Berhad, "Maybank Islamic Ikhwan Card-i - Conversion from Bai' Inah to Ujrah Sharī'ah Contract," accessed 23 January 2013, <http://maybankislamic.com.my/download/Ujrah-Announcement.pdf>.

<sup>635</sup> Ibid.

<sup>636</sup> Ibid.

- (ii) The relationship between the cardholder and the bank is regulated through a loan contract, where the cardholder is the borrower and the bank is the lender. Every transaction made by the cardholder is considered a loan from the bank to the cardholder.
- (iii) The cardholder uses his credit card to purchase goods and services from merchants.
- (iv) The bank then guarantees the payment and pays the amount owed by the cardholder to the merchants.
- (v) Afterwards, the bank claims back from the cardholder the original amount of debt and charges the guarantee service that the bank provides to the merchants.

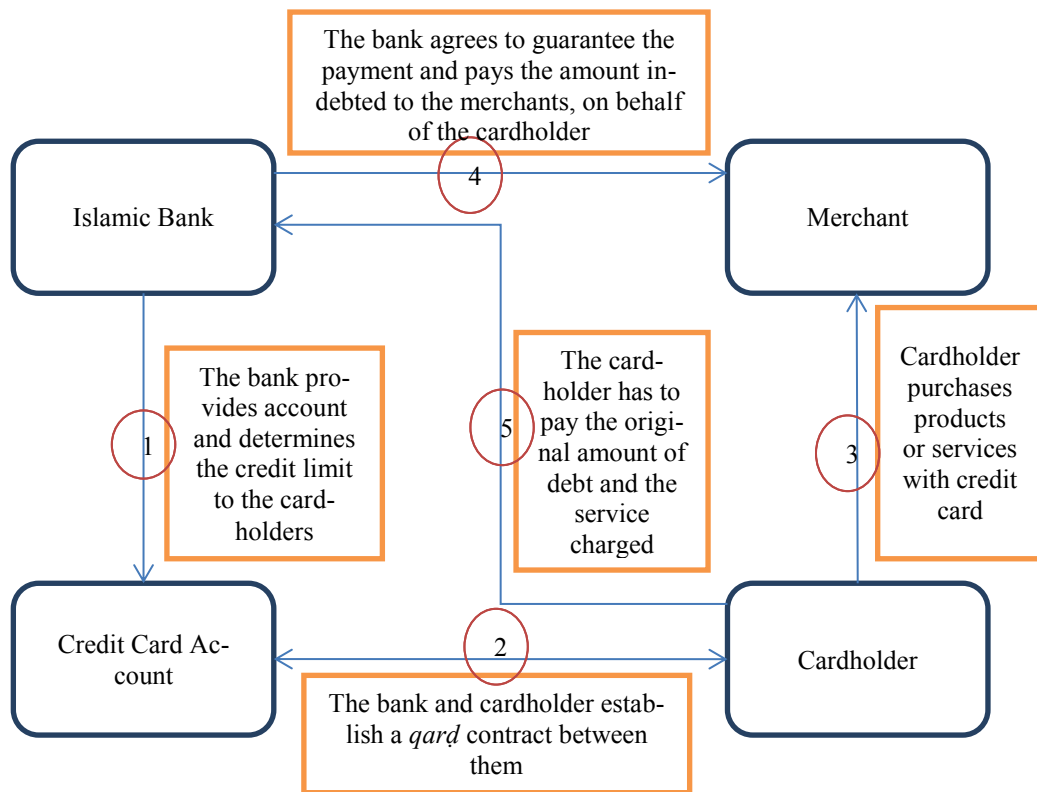


Figure 5: Islamic Credit Card using *Ujrah* and *Kafalah* Concept<sup>637</sup>

<sup>637</sup> This figure was modified from Engku Rabiah Adawiyah Engku Ali (2008) a member of the SACBNM and Ruslena Ramli (2008) manager of EONCAP Islamic Bank. The elaborated models of credit card, as explained by both authors are significantly no difference with the conceptual frameworks of Islamic credit card based on *ujrah* offered by Maybank Islamic, thus it is applicable to the latter. Engku Rabiah Adawiah, "Bay' al- 'Inah and Tawarruq," 155; Ruslena Ramli, "Innovation in Islamic Retail Products: A Comparative Update Between GCC And Malaysia," (Presentation at the International Islamic Finance Forum - Dubai, 13-17 April 2008, accessed on 22 January 2013, Continued on next page...

Since the bank does not provide the illustration of the credit card's structure, the paper has adopted the model introduced by Engku Ali (2008) and Ramli (2008). Based on our observation, the model is similar to the structure of the credit card offered by the bank. The fees imposed are justified through the services provided by the bank based on the *ujrah* concept, which range from managing and maintaining accounts as well as guaranteeing (*kafālah*) payments to merchants. It has shown the fees charged comprise of a cash advance fee on flat rate of 5% of the total amount of cash advancement (minimum RM10). Furthermore, the bank also charges card replacement fee (RM50 for the first replacement), sales draft retrieval fee (RM15), and additional statement request fee (RM5 per month statement). Service tax is also imposed (RM50 annually and RM25 service tax levied on each principal and supplementary card, respectively), which will be deducted from the cardholder's card account at the time when the card is issued, on the anniversary date or upon renewal the card.

The final fee is charges on the outstanding balance, which is also known as Actual Monthly Management Charge (AMMC) levied on the outstanding retail transaction balances, which are not paid after the payment due. The AMMC will be calculated from the day the transactions were posted until full payment. Retail transactions are excluding cash withdrawal balance transfer and any other credit plans. The structure of fees is presented in the table 2:

| Conditions / Payments Months / Total 12 Months | Charges |        |
|--|---------|--------|
| For Prompt Payment 12/12 months                | 1.13%   | 13.50% |
| For Prompt Payment 10/12 months                | 1.33%   | 16%    |
| For Prompt Payment of less than 10/12 months   | 1.46%   | 17.50% |

Table 3 : Actual Monthly Management Charge (AMMC)

On the other hand, if the cardholder wishes to withdraw cash, different fees are enforced, which are known as Actual Cash Withdrawal Management Charge (ACWMC). ACWMCs are imposed on the one-time service fee of 5 % charged on the cash amount withdrawn through the use of the card in which the minimum amount

<http://ara.assaif.org/International-Events/2008/The-International-Islamic-Finance-Forum-Dubai,-13-17-April-2008>.

withdrawn is RM10. ACWMCs also are charged on the outstanding balance due to the cash withdrawal and other credit plans, which will be subjected to the ACWMC of 1.5% per month and effective rate of 18% per annum. The charges will be calculated on a daily basis from the date of the cash withdrawal until full payment is received and credited into the card account. However, if the cardholder fails to satisfy his obligation to pay, the minimum requirement of 5%, late payment penalty (*ta'wid*) will be charged, of 1% of the minimum repayment amount due or a minimum of RM5, whichever is higher up to a maximum of RM50, which includes other related charges. The bank also does have the right to offset any facility balance from the cardholder's account, for example savings account or investments account, maintained within the bank against any outstanding balance of the cardholder.

| Service Fee                                      | Charge  |
|--|---|
| One-time fee of 5% on the cash withdrawal amount | 18% per annum on the outstanding balance of cash withdrawal |

Table 4 : Fees for Actual Cash Withdrawal Management Charge (ACWMC)

Besides, the bank also charges Fixed Monthly Management Charges (FMMC) for the services provided by the bank, and Fixed Monthly Cash Withdrawal Charges (FMCWC) for cash withdrawal transactions in which these charges are the capping amount of AMMC and ACWMC, respectively. In the event the AMMC exceeds the FMMC, the bank shall only charge up to the FMMC limit. This is also applied to the FMCWC, which is also a capping amount for ACWMC. If the ACWMC exceed the FMCWC, the Bank shall only charge up to the FMCWC limit.

| Gold     | Platinum   | Infinite    |
|----------|------------|-------------|
| RM900.00 | RM3,600.00 | RM30,000.00 |

Table 5 : Fixed Monthly Management Charges (FMMC)

| Gold       | Platinum   | Infinite    |
|------------|------------|-------------|
| RM1,300.00 | RM5,300.00 | RM44,300.00 |



Table 6: Fixed Monthly Cash Withdrawal Charges (FMCWC)

The bank also may grant the cardholder a rebate (*ibrā'*) based on its own discretion at any time or from time to time, which will be determined and calculated at the absolute discretion of the bank. The amount of the rebate (*ibrā'*) of FMMC will be determined, according to the difference amount between the FMMC and the AMMC at the relevant statement date. The same rebate is also offered to FMCWC, where it is calculated based on the difference amount between FMCWC and ACWMC at the relevant statement date. Another consideration to actualise the rebate is through AMMC on the current balance, where it must be lesser than the FMMC. In the same vein, the rebate also will be offered for cash withdrawal if FMCWC on the current balance is lesser than the ACWMC.

#### 5.2.4. Sharī'ah Issues

It is observed the monthly and withdrawal fees are tied to the outstanding balance of the debt owed. This practice is equivalent to the exchange of money for money, which is *ribā*. This can be noticed the monthly and withdrawal fees, namely AMMC and ACWMC are different in accordance to the outstanding balance of debt owed. The cardholder has to pay extra rate based of the outstanding amount and the charges are increased, if he keeps delaying the payment. This is considered as *ribā al-qarḍ*, since the cardholder has to pay an additional charge to the bank (lender) beside the principal amount if he delays the payment. However, there is no Sharī'ah issue to administrative and management fees, such as replacement card's fee, sales draft retrieval fee, additional statement request fee, FMMC and FMCWC, which are fixed and do not reflected of to the amount of money owed. In this regard, Kenjebaev (2012) asserted monthly and withdrawal charges are similar to interest charges. However, he opines fixed monthly charges, such as loyalty programmes, discounts on the purchases by using credit card and guaranteeing the payment to the merchants on every purchase on behalf of the cardholder, are not akin to interest but can be justified, as compensation for the services provided by the bank to its cardholders. He reinforces the fixed fees are charged for the services provided rather than for the money advanced to the cardholder. He, furthermore, explains the cardholder utilise money advanced by the bank as a debt has to be repaid. The bank does not charge any additional fees in case of delay of pay-

ment by the cardholder. He observed the payment of the fixed fees should not be considered as interest for the money utilized but as an *ujrah* for the services provided.<sup>638</sup>

Furthermore, the bank also did not provide a valid reason for the charges imposed on the cardholder partially settles his debt, whether of late payment or due to the operational cost of the delayed payment. If the charges imposed are in the form of a penalty for late payment, the SACBNM then stipulates Islamic banks may impose the charges but they must be based on the actual losses.<sup>639</sup> The council however decided the percentage of 8% could be imposed as a penalty charge. However, the council was silent on the justification of 8%, why the penalty was allowed. Another question is how Islamic banks would calculate the actual loss, as to whether it would be based on the opportunity cost by the bank or other means.<sup>640</sup> Furthermore, if the charges are imposed based on the cost of operation of the delayed payment, then it is considered, as a benefit to the loan given, which is *ribā*. Majority of Muslim jurists argued the practice is equivalent to the Prophet said that “every loan, which brings benefits (to the creditor) amounts to *ribā*”. According to Baz (2013), although the saying of the Prophet (s.aw.) is weak, but the meaning is valid.<sup>641</sup>

In addition, the structure of the product is seemed similar to the issue of combination of sale and loan in the Shari‘ah. Combination of sale and loan was prohibited by the Prophet (s.a.w.). This was stated in his famous *ḥadīth*, “it is prohibited to combine loan and sale”.<sup>642</sup> A standard interpretation of the *ḥadīth* is the loan contract stipulated in a sale contract or a sale contract stipulated in the loan contract. If the contract is made in a separate deal, where there is no stipulation between both contracts, then it is permissible<sup>643</sup>. However, it is prohibited, if sale and loan contracts are combined to-

<sup>638</sup> Nurbek Kenjebaev, “Shari‘ah-Compliant Credit Cards an Analysis of Underlying Structures,” *ISRA International Journal of Islamic Finance* 4, no. 1 (2012):129-149.

<sup>639</sup> BNM, *Shari‘ah Resolution*, 133.

<sup>640</sup> Rosly, *Critical Issues on Islamic Banking*, 42.

<sup>641</sup> According to Shaykh Bāz (Grand Mufti of Saudi Arabia), although this *ḥadīth* is weak but the meaning is sound and applicable to the interpretation of *ribā*. This is because every loan that brings any benefits to the creditor is considered usury, as the benefit obtained is conceded as an increment to the principal that is obligated to be paid by the borrower. ‘Abd Azīz ibn ‘Abd Allāh ibn Bāz, “Fatāwī: *ḥadīth kul qarḍ jarr naf‘ā fahu ribā*,” accessed on 1 October 2013, <http://www.binbaz.org.sa/mat/3994>. See also Ibn Hajar al-‘Asqalānī, *Bulūgh al-Marām*, 176.

<sup>642</sup> Al-Ṣan‘ānī, *Subul al-Salām*, vol. 5, 38-39; Muḥammad Ibn ‘Alī Ibn Muḥammad al-Shawkānī, *Nayl al-Awtar Sharḥ Muntaqā al-Akḥbār* (Bayrūt: Dār al-Kutub al-Ilmiyah, 1403H), 179 [ḥadīth no. 2224]; Muḥammad ibn ‘Abd Allāh Ibn ‘Arabī, *Ārīḍat al-Aḥwadhī bī Sharḥ Ṣaḥīḥ al-Tirmīdhī* (al-Qāhīrah: Maṭba‘ah al-Ṣāwī, 1353H), vol. 5, 241.

<sup>643</sup> Muḥammad ibn Abī Bakr Ibn Qayyim al-Jawziyyah, *Tahdhīb Mukhtaṣar Sunan Abī Dawūd* (Al-Qāhīrah: al-Sunnah al-Muḥammadīyyah, 1369H), vol. 5, 106; Hammad, *al-Uqūd al-Murakkabah*, 6; AAOIFI, *Al-Ma‘āyir al-Shar‘īyah*, 458-459.

gether. It has been agreed the ruling of the prohibition of combination of sale and loan is also has been extended to other contracts that share the similar features of both contracts. *Qarḍ* is categorized as non-exchange contract (e.g. *hibah* and *sadaqah*), while sale is exchange contract (e.g. *ijārah* and *salam*), therefore the combination of non-exchange with exchange contracts is also prohibited. The reason of the prohibition is the combination has been used as a legal trick to circumvent *riba* (Hammad, 2005).

In this respect, the combination of sale and loan can be observed in the arrangement, as it combines *qarḍ* (non-exchange contract) and *kafālah bi al-ujr* (exchange contract). The involvement of bank and cardholder in *qarḍ* contract can be seen in the Figure 1, where it is stated clearly the bank is the lender to the cardholder and the cardholder is the borrower. When the bank issues a credit card to the cardholder, it is directly/automatically meant the bank has given credit/advance money/loan or *qarḍ* in the paper for the cardholder to utilise it in purchasing goods and services. Although the cardholder never ask or agreed upon with the bank to enter into loan contract, but when the bank issued the credit card to the customer, it is considered as a facility/advanced money/credit within the limit approved for the customer to enter into loan contract with the bank. This can be evidenced that the customer is required to pay the amount spent with the bank and the bank is obligated to pay back the amount spent by the cardholder to the merchant/seller. This is also applied to withdrawal cash in which the cardholder inevitably owes to the bank, where the former is obligated to pay back the amount of withdrawal with extra charges if he/she delays the payment to the latter.

Notwithstanding, the contract of *kafālah bi al-ujr* as an exchange contract comes to the arrangement, since the bank guarantees the purchasing made by the cardholder. The power of purchasing goods and services emanates from the credit (*qarḍ*) authorised by the bank and the cardholder is allowed to delay his payment with extra charges based on the period of payment made by the cardholder. This indicates there is a direct relationship between *qarḍ* and *kafālah bi al-ujr*, where the presence of *kafālah bi al-ujr* is due to the *qarḍ* given by the bank and without *qarḍ*, the contract of *kafālah bi al-ujr* will not be existed. In this respect, it is seemed that the practice of the bank was contradicted to the recommendation made by AAOIFI and IFAOIC. The councils resolved that the issuer may charge a commission fee to the merchants on every purchasing made by the cardholders, at the purchase price of the items and services bought on the card, as well as membership, renewal, and replacement fees to the cardholder or withdrawal cash with flat fees, but not the guarantee element. Therefore, the arrange-

ment is invalid as it is a combination of sale and loan contract, which becomes a legal trick to circumvent *ribā*.

Credit card is important for the cardholder to purchase goods and services easily based on credit. From the Sharī'ah perspective, credit card is allowed as long as it does not involve any *ribā* element. Majority of Sharī'ah scholars and institutions, such as AAOIFI, IFAOIC and SACBNM agreed that the issuer/bank is allowed to charge some fees, such as membership, renewal, or replacement fees, where no interest is engaged. Such fees are not regarded as a lucrative profit for the bank, since the rates are predetermined, where the bank is not allowed to raise the amount. However, charging fee on guarantee is still controversial since, it has been regarded as *ribā*. In conventional banks, the institutions generate their income/profit via the interest charges based on the outstanding balance. If the cardholder defers in paying the amount due, he/she will be charged based on the percentage stated in the product. However, such mechanism is not allowed under the Sharī'ah provisions, as it is similar to *ribā*. The bank is only allowed to charge minimum fee, as a penalty, if the cardholder delays the payment.

It is observed that the main problem of the product is the monthly and withdrawal fees, which are equivalent to *ribā*. To solve the problem, it is suggested that the bank may retain FMMC and FMCWC but has to eliminate the AMMC and AMCWC in tandem with the resolution made particularly by IFAOIC, SACBNM and AAOIFI that only fixed administrative and management fees are allowed. The bank also may charge fee based on the types of purchased items by the cardholder, such as food, clothes, or utilities. In this case, the bank is required to cooperate with the selected business outlets in which every purchasing made by cardholder, there is some profit shared by the owner of the outlet and the bank. However, this practice is probably not practical, since not many outlets and shops would share the profit. Other alternative, the bank also may generate profit without charging AMMC and AMCWC through promotion and marketing strategies to encourage the cardholder to spend more on retail purchases. This effort is, on the other hand in tandem with the principles of Islamic legal maxims; *al-kharaj bi al-daman* (revenues comes with liability) and *al-ghunm bil ghurm* (profits goes with loss) that propose any profitability, revenues and proceeds must be corroborated with the legal efforts embedded.

Regarding the issue of combining exchange and non-exchange contracts between *qard* and *kafālah bi al-ujr*, it is proposed that the bank instead structure the Islamic credit card based on the concept of *takāful*. This is proposed to resolve the con-

troversial issue of combining exchange and non-exchange contracts, which is tantamount to *ribā*. Under the concept of *takāful*, the concept of guarantee is still applicable, where the cardholder is a policyholder and the bank is the manager of the fund to guarantee the payment spent by the cardholder. The payment of the cardholder can be divided into two accounts, one for *tabarrū*<sup>644</sup>, which attempts to cover the risk exposed by the cardholder, and the other account for investment. Meanwhile, the premium paid is based on the credit assessment and risk profile of the cardholder. The bank may invest the premium given into Sharī'ah-compliant ventures to realise some profits based on the contract of *wakālah* or *mudārabah*, which becomes an incentive to the bank and the cardholder. However, if the bank is still interested to offer Islamic credit cards based on the *ujrah* contract, the bank should ensure that the fees imposed are fixed and not tied to the amount of outstanding balance; otherwise the transaction will involve *ribā*.

### 5.3. Case II: Islamic Mortgage (*Rahn*) of Personal Loan

#### 5.3.1. The concept of *rahn*

Mortgage or *rahn* in the Sharī'ah refers to holding an item by the mortgagor in lieu of a legal right that may be satisfied from the item, as guarantee against a debt. In the event of defaulting to pay the debt, the mortgagor/creditor may sell the item to compensate his debt.<sup>644</sup> In Islamic banking practice, credit facility offered will normally be secured by a suitable collateral or mortgaged asset with adequate value. Assets such, as property, share and investment certificates, land, house, or precious metal of gold or silver are accepted as mortgaged asset. *Rahn* is also regarded as a supporting contract to guarantee loan contract, and without loan contract, it does not exist. For example, in house financing, operated under the concept of *murābahah*, *rahn* is used as a supporting contract to *murābahah* contract, where the house becomes the mortgaged item for the bank to secure the customer's debt. If the customer fails to pay the debt, the house will be auctioned or sold to compensate the debt.

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<sup>644</sup> Mortgagee in this respect may be a lender or seller, who gives permission to the buyer to pay his debt in deferred payment. Wahbah al-Zuhāyī, *Financial Transaction in Islamic Jurisprudence*, translated by Mahmoud A. El-Gamal (Bayrūt: Dār al-Fikr, 2002), vol. 2, 79.

In Malaysia, conventional pawn broking's business is controlled by the Pawn-brokers Act 1972 and regulated by the Ministry of Housing and Local Government, whereby Islamic pawn broking or mortgage is regulated by the IFSA 2013. *Rahn* has been used for various purposes, such as to finance SME for working capital and personal loans. It was introduced as an alternative to the conventional mortgage's system that charged interest, which is prohibited by the Sharī'ah. It gained popularity because of its attractive features that make it competitive with its conventional counterparts. Among the factors that attracted these institutions to offer the scheme is the security and safety of loan given to the customer. In the event of default/failure to meet the debt obligation, the bank as mortgagee can dispose of the gold bar/jewelry at market value to recover back the customer's outstanding debt, thus the product has a low risk profile. As the loan's payment is secured, accordingly, the bank has no qualm about giving the loan to the customer and the process of approval is swifter than the normal personal financing without mortgage. Furthermore, another advantage of having this product, for bank, is that it can generate a profitable dealing, as the "charges of profit" is higher than normal rate of profit imposed to personal financing.<sup>645</sup>

The first Islamic mortgage system was introduced by Mu'assasah Gadaian Islam Terengganu on January 23, 1992, as a subsidiary of State Government of Terengganu.<sup>646</sup> A year later, another Islamic mortgage institution, namely Kedai Pajak Ar-Rahnu (Pawn Shop Ar-Rahnu) was opened by the State Government of Kelantan in March 1992. Bank Kerjasama Rakyat Malaysia or normally known as Bank Rakyat with cooperation of the Malaysian Islamic Economic Development Foundation (Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM)), was the first Islamic bank to introduce the service on October 27, 1993. This was followed by BIMB in November 1997.<sup>647</sup> Presently, there are seven Islamic banks that offer the scheme, however

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<sup>645</sup> Mohamed Fairouz Abdul Khir, Mohd Bahroddin Badri, Lokmanulhakim Hussain, "Critical Appraisal of the Rahn-Based Islamic Microcredit Facility," 1-50 (ISRA Research Paper no. 45/2012, International Sharī'ah Research Academy, 2012)

<sup>646</sup> Shamsiah Mohamad, "Perlaksanaan Gadaian Islam di Institusi-Institusi Gadaian Islam di Malaysia: Kajian Kes di Mu'assasah Gadaian Islam Terengganu (The Implementation of Islamic Mortgage in the Islamic Mortgage Institutions of Malaysia: A Case Study of the Institution of Islamic Mortgage of Terengganu)," (MA diss. University of Malaya, 1994), 128-156.

<sup>647</sup> Later the development of Islamic mortgage's scheme was then introduced by Agriculture Bank of Malaysia in September 2, 2002 and EON Bank Group (now a subsidiary of Hong Leong Bank) in the same year. The scheme also has been offered by other institutions of cooperatives and state governments, such as the Perlis State Government has established Islamic Pawnshop in January 1997 and Pahang Consumer Cooperative Limited in 2003. Shamsiah Mohammad and Safinar Salleh, "Upah Simpan Barang Dalam Skim al-Rahnu: Satu Penilaian Semula," (Fees for Safekeeping in al-Rahn's Scheme: A Reas-

*Continued on next page...*

only four banks provide the information in detail about the product on their website (see table 7).<sup>648</sup>

| No. | Islamic Banks                     | Concept Applied   | Quantum of Financing  | Repayment Period                  | Pawn Product            |
|-----|-----------------------------------|---|---|-----------------------------------|-------------------------|
| 1.  | Bank Rakyat <sup>649</sup>        | <i>al-wadī'ah yad ḍa-mānah and qarḍ al-ḥasan</i>              | Min: RM 100<br>Max: RM 10,000   | 6 months<br>6 months (ex-tension) | Gold/Jewelry<br>18k-24k |
| 2.  | Agro Bank <sup>650</sup>          | <i>al-wadī'ah yad ḍa-mānah, al-qarḍ and al-ujrah</i>          | Min: RM 100<br>Max: RM 50,000   | 6 months<br>3 months (ex-tension) | Gold                    |
| 3.  | RHB Islamic Bank <sup>651</sup>   | <i>al-wadī'ah yad ḍa-mānah, al-qarḍ, al-ujrah and al-rahn</i> | Min: RM 100<br>Max: 70% of the current market value of the jewelry <sup>652</sup> | 6 months                          | Gold                    |
| 4   | Affin Islamic Bank <sup>653</sup> | <i>al-qarḍ</i>  | Min: -<br>Max: 70% of the current market value of the jewelry                     | 6 months<br>3 months (ex-tension) | Gold                    |

Table 7: List of Islamic Bank in Malaysia Offered *Rahn* Product

The amount of financing depends on the policy of the bank and the quality of the mortgaged asset. For example, RHB Islamic Bank offers the minimum amount of RM 100 and the maximum amount of RM 50, 000, and the period of repayment of the loan is six months. The customer is also allowed to revolve the debt from three to six months, if the borrower is not able to pay the debt on time. Normally, the stipulation to

sessment), *Jurnal Fiqh*, 5 (2008): 47-65; M.T. Skully, "Islamic Pawn broking: The Malaysian Experience," (paper presented at the 3<sup>rd</sup> International Islamic Banking and Finance Conference 2005, organized by the Monash University Malaysia, RHB Bank and ALDWICH WIPRO on 17<sup>th</sup> November, 2005, Kuala Lumpur, Malaysia); Azila Abdul-Razak, "Economic and Religious Significance of the Islamic and Conventional Pawnbroking in Malaysia: Behavioural and Perception Analysis," (PhD diss., University of Durham, 2011), 85.

<sup>648</sup> There are another three banks, namely Bank Islam Malaysia Berhad, Bank Muamalat and CIMB Islamic do not provide information regarding *rahn*.

<sup>649</sup> *al-wadī'ah yad ḍa-mānah* (safekeeping with guarantee, where the bank will treat the asset/money as a loan), and *qarḍ al-ḥasan* (benevolent loan-loan without any compensation). Bank Rakyat, "Pawn broking-I Ar-Rahnu," accessed on 11 February 2013, <http://www.bankrakyat.com.my/web/guest/arrahn>.

<sup>650</sup> The definition of *al-wadī'ah yad ḍa-mānah and qarḍ al-ḥasan* is similar to footnotes 54, whereas *ujrah* is fee paid by the customer due to the safekeeping of the asset of the customer. Agrobank, "Ar-Rahnu Agrobank," accessed on 11 February 2013, <http://www.agrobank.com.my/ar-rahnu>.

<sup>651</sup> Only selected branches provided the facility, RHB Islamic Bank, "Ar-Rahnu-I," accessed on 11 February 2013, [http://www.rhb.com.my/islamic\\_banking/Ar-Rahnu-i/main.html](http://www.rhb.com.my/islamic_banking/Ar-Rahnu-i/main.html).

<sup>652</sup> 75% of the current market value of the jewellery for customers who sign up with RHB Islamic will writing facility (*wasiat*) and only one time per customer. Ibid.

<sup>653</sup> Affin Islamic Bank, "Ar Rahnu Facility-i," accessed on 11 February 2013, <http://www.affinislamic.com.my/banking/personal/arrahn>.

extend the payment is that the customer is required to settle the safekeeping fees for the past six months. Most of the pawn objects accepted by the bank are gold or ornaments made from gold such as necklace, ring, earrings, and lockets. Some of the banks stipulate very specific gold, such as Affin Islamic Bank and RHB Islamic Bank; it only accepts items that are made from the gold types of 999, 950, 916, 860, and 750.<sup>654</sup>

*Rahn*-financing facility is considered an expensive product as compared to a personal loan. For example, rate of personal loan for government employees, is between 3 - 5 %, since their risk of default is lower than the non-government employees, which may increase up to 11%. As compared to *rahn* facility, the average storage fee imposed is between 1 % per month up to 12 % per year, depending on how long the item is stored in the bank. The longer the period of storage the more the customers have to pay.<sup>655</sup> Nonetheless, this facility is preferred by the customer because they can enjoy quick approval of the application. They also can opt to rollover the outstanding amount of the debt, particularly in the event of defaulting, to meet their debt obligation. Furthermore, the jewelry mortgaged, which sometime have sentimental values to the owner can be reimbursed after all the debt is settled. The Islamic banks are also willing to give the loan because they have secured the financing through the mortgaged item with them. If the customers were to default, they would sell the item to secure the debt.<sup>656</sup>

### 5.3.2. Shari'ah rulings of *rahn*

Realizing that the issue of *rahn* is very important, the AAOIFI and the SACBNM have issued a standard and resolutions for *rahn* contracts. In the Shari'ah standards issued by the AAOIFI, it is stated that the purpose of *rahn* is to secure the payment of debt owed by the borrower to the lender/seller (in the case of deferred payment).<sup>657</sup> If the debtor defaults on his obligation, he cannot forbid the seller/lender from selling or disposing of the asset to compensate for debt owed. It is also stipulated that

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<sup>654</sup> There are several processes to identify the finesses of the gold and the most popular is fire assay. It is a process that involves melting a gold-bearing sample in a clay crucible with a mixture of fluxes (such as silica and borax), lead oxide (called litharge), and a reducing agent (frequently flour). See furthermore in Britannia Encyclopedia, "Gold Fitness," accessed 11 February 2013, <http://www.britannica.com/EBchecked/topic/207276/fineness>.

<sup>655</sup> Abdul Khir, *et. al.* "Critical Appraisal," 1-14

<sup>656</sup> Ibid.

<sup>657</sup> The AAOIFI has issued two standards with regard to mortgage, namely standard no. 5, which is mixed with the issue of guarantee, while the standard no.39 is reserved solely on the matter, which on the other hand is to reinforce the former. AAOIFI, *Al-Ma'āyir al-Shar'iyyah*, 62-78; 693-714.



the contract is binding, although the mortgaged asset is not owned by the mortgagee and the mortgagor cannot revoke the contract unilaterally. The mortgaged asset must be valuable, lawfully owned, and sold, tangible, yet it can be debt, cash, fungible asset, or consumable commodity. The same asset can be pledged more than one mortgagee (person who charges the asset) and it is still possessed by the mortgagor (person who give the asset), which is kept under the mortgagee as a trust, as long as it is mortgaged. When the mortgaged asset perishes while in the hand of the mortgagee, he is not obliged to reimburse or compensate the asset, except if it is proven to be due to his negligence and transgression. In addition, the most important precept is that the mortgagee has no right at all to benefit or to enjoy the benefits produced from the mortgaged asset *with* or *without* permission of the mortgagor.<sup>658</sup> This is purposely formulated to avoid any benefits accrued from the loan given. If the object of *rahn* can be benefited by the mortgagee, then it is equivalent to the definition of *ribā*. Furthermore, the mortgagor should bear all costs and expenses related to the safekeeping and the mortgagee may recourse the compensation of the costs from the mortgagor.<sup>659</sup>

Meanwhile, the resolutions issued by the SACBNM are too concise, as compared to the AAOIFI's standards.<sup>660</sup> Most of the resolutions discussed are only related to the mortgaged assets, for example, whether it is permissible for the mortgagee to use the mortgaged asset to secure two financing facility, or whether conventional fixed deposit and Islamic debt securities can be mortgaged asset or the issue of sale of mortgaged asset in the event of default.<sup>661</sup>

### 5.3.3. The case of Bank Rakyat's personal financing

Bank Rakyat was established on 28 September 1954 under the Cooperative Ordinance 1948. Today, Bank Rakyat is the biggest Islamic cooperative bank in Malaysia with assets totalling RM79.21 billion, as at the end of 2012. It has 142 branches with more than 600 automated teller machines (ATMs) and cash deposit machines (CDM), and 56 Ar-Rahnu X'Change nationwide.<sup>662</sup> There are two types of *rahn* products of

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<sup>658</sup> Ibid., 699.

<sup>659</sup> Ibid.

<sup>660</sup> For further comparison of the classical texts of *rahn* between four *madhhab*, one may consult with the work of al-Zuhāyī, *Financial Transaction in Islamic Jurisprudence*, 286-302.

<sup>661</sup> BNM, *Sharī'ah Resolutions*, 53-61.

<sup>662</sup> Bank Rakyat, "About Us," 16 October. 2013, [http://www.bankrakyat.com.my/web/guest/about\\_us](http://www.bankrakyat.com.my/web/guest/about_us).

personal financing offered, which are under consumer product by the bank, namely Pawn Broking-I and Pawn-Broking-i Az-Zahab. Pawn Broking-I aims to provide an immediate personal financing for individuals to overcome cash-flow needs. Under this product, the quantum of financing is given up to 70% of the mortgaged gold, and each gold value must not exceed RM 10,000 and a cumulative amount is not exceeding RM 50, 000. The repayment period is only 6 months and an extension period is only permitted for 6 months subject to the settlement of safekeeping fee for the past 6 months. The type of gold jewelry must be among 18 karat to 24 karat.

Meanwhile, Pawn-Broking-i Az-Zahab is an extension of the first Ar-Rahnu scheme, in which the bank offers a higher facility amount and a longer repayment period. The quantum of financing is given still up to 70% of the gold value but each mortgaged item must exceed RM 10, 001 and a cumulative value of the gold must not exceed RM 100,000. The repayment period is given up to maximum 36 monthly instalments or lump sum payment for a 6 months period. The mortgaged assets must be gold jewellery 18 karat until 24 karat.<sup>663</sup> (See the safekeeping fees charged of both products in the table 8).

Normally, four contracts are utilized to structure the product, namely *qard al-hasan*. It is an interest free loan, where the borrower/customer is required to pay only the principal amount borrowed. Under this product, the Bank will grant the loan to the customer and the customer will mortgage his/her gold jewelry as surety for the said loan. The same amount is to be repaid to the Bank by the Customer on maturity or on demand. Second contract is *rahn*- a valuable asset will be mortgaged as collateral for a loan granted. Under this product, gold jewelry serves as collateral to the loan. In the event of default, the mortgaged asset will be auctioned to recover the loss. Any surplus will be returned to the customer while the shortfall is to be repaid. Third contract is *uj-rah*, which refers to charging a fee for services provided. Under this product, the Bank will charge a reasonable safekeeping fee for keeping the gold jewelry in a safe condition during the loan tenure. Finally, the forth contract is *wadī'ah yad amānah*, which refer to safekeeping with trust or without liability. In other words, it refers to an agreement for the placement of the assets or money with another person for safekeeping and the safe keeper has no liability to compensate the property/ asset kept, except due to his

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<sup>663</sup> Bank Rakyat, "Pawn Broking," accessed on 16 October 2013, <http://www.bankrakyat.com.my/web/guest/ar-rahnu>.

negligence. Under this product, the Bank promises to keep the gold jewelry in its custody during the loan period and the Bank shall be responsible to replace the gold jewelry to the customer should the gold jewelry goes missing or stolen. If it is not due to bank's negligence, the bank is not required to replace the gold jewelry.<sup>664</sup>

| Name of Product         | Margin of loan      | Safekeeping fees for every RM100 of mortgaged value |
|-------------------------|---------------------|---|
| Pawn Broking-I          | RM 100-RM 1,000     | RM 0.65   |
|                         | RM 1,001-RM 10,000  | RM 0.75   |
| Pawn-Broking-i Az-Zahab | RM 10,001-RM100,000 | RM 0.75   |

Table 8: The Safekeeping Fees Charged

However, Bank Rakyat does not specify in detail each contract involved in the structure of the product. It just briefly states that there are two contracts engaged, namely *wadī'ah yad amānah* and *qarḍ al-ḥasan*. Each contract must be concluded separately and does not have any relationship to one another. *Rahn* is regarded as a supporting contract to *qarḍ al-ḥasan* in guaranteeing the payment of the loan. Meanwhile, *ujrah* is regarded as a fee for *wadī'ah yad amānah*. The structure of the product can be delineated, as follows:

- (i) The customer applies for loan from the bank under the concept of *qarḍ al-ḥasan*.
- (ii) The bank stipulates that the customer must pledge an asset to secure the debt.
- (iii) The customer surrenders the mortgaged asset and it is kept under the concept of *wadī'ah yad amānah*.
- (iv) The customer pays *ujrah* for the safekeeping of the mortgaged asset.

<sup>664</sup> Abdul Khir, *et. al.* "Critical Appraisal," 14

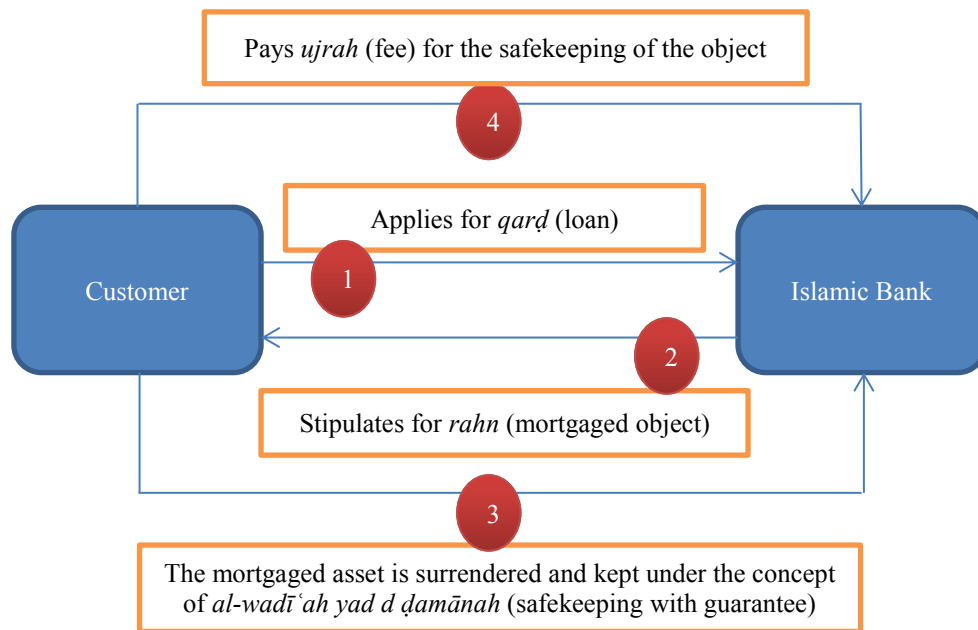


Figure 6: *Rahn* Structure

The safekeeping fee's calculation can be illustrated, as follows: For example, mortgaged asset's value: RM10, 000; Loan Tenure: 6 months; Loan Amount (70% from the mortgaged asset's value): RM7, 000. Hence, total safekeeping fee = mortgaged asset's value X safekeeping fee X loan tenure;  
 $= \text{RM}10,000 \times (\text{RM}0.75/100) \times 6 \text{ months};$   
 $= \text{RM}450.00$

The calculation of safekeeping is one-month calendar, where it is counted from a point-to-point basis. For instance, a customer applies for a loan on January 1, 2013, thus the one-month calendar is fixed on February 1, 2013. However, if the customer redeems the mortgaged asset earlier than the fixed date, the bank has the right to claim the full amount of one-month calendar. This obviously gives more advantage to the bank where it does not tolerate to reduce the fees charged, and probably one of the justifications is that the charge has been agreed in advance by both parties; the bank and customer. In this regard, it seems that the daily calculation gives more advantage to the customer, if he hesitates or does not have any fixed date to redeem his mortgaged asset.

#### 5.3.4. Shari'ah issues

The main issue in the structure of the product is safekeeping fee: It is observed that the safekeeping charged fee on the mortgage asset is in lieu of the loan given,

which is not in tandem with the original principles of the *rahn* contract. This is because *rahn* is a supporting contract to ensure that the debt owed by the mortgagor/borrower will be paid back. If the mortgagee charges any safekeeping fee, then it is similar to the benefit gained from the loan given. However, there is an opinion that the mortgagee may charge the storage fee, if the mortgagee incurs some costs to keep the asset.<sup>665</sup> Referring to the standard of AAOIFI, it merely addresses that the mortgagee cannot utilize the asset, either “*with or without*” permission of the mortgagor, i.e. the real owner of the asset, because the utilization of the asset seems to generate benefit in excess of the loan given. When the mortgagee pays such expenses “*with or without*” the permission of the mortgagor, he has the right of recourse on the mortgagor for compensation or he may obtain compensation in terms of an equivalent period of benefiting from the mortgaged asset. The AAOIFI’s standard also explains that mortgagee should bear all the expenses relating to safekeeping, documentation and selling of the mortgaged asset, except when the two parties agree that the mortgagor should bear such expenses. However, the SACBNM does not address any decision related to the issue. Even so, the *Fatwā* Committee of the National Council for Islamic Religious Affairs Malaysia<sup>666</sup> in its 78<sup>th</sup> meeting on June 12, 2007 ruled that the mortgagee could propose wage rate in order to maintain *rahn* scheme in Islamic banking.<sup>667</sup>

If we observe the Shari‘ah standard issued by AAOIFI, the safekeeping can be imposed to the mortgaged asset, where it causes some costs to the mortgagee. The mortgagee can impose the fee based on the real cost incurred by the mortgagee. In this context, the mortgagee could not charge the safekeeping fee as a business, as what is done by Bank Rakyat. If we observe from the table 8, it appears that the bank charges the safekeeping fee based on the loan amount to the borrower, and not the real cost of keeping the gold incurred by the bank. This indicates the bank does not relate to any cost of safekeeping, but to loan given. This practice is equivalent to the interest charges to the loan. Although, the safekeeping fee is charged based on the value of the mortgage asset to escape from the prohibited relationship of the amount of loan given, but

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<sup>665</sup> Ibid., 15-17.

<sup>666</sup> Department of Islamic Development Malaysia (JAKIM), About MKI, accessed on 20 February 2013, <http://www.e-fatwa.gov.my/jawatan kuasa-fatwa-majlis-kebangsaan-bagi-hal-ehwal-ugama-islam-malaysia>.

<sup>667</sup> See the rate of safekeeping fee accepted by the Fatwa committee, accessed on 20 February 2013, <http://www.e-fatwa.gov.my/fatwa-kebangsaan/penentuan-hukum-syarak-di-dalam-pelaksanaan-skim-pajak-gadai-islam-al-rahn-di-malay>.

this method is not free from the prohibition. It seems that the mortgagee attempts to treat the safekeeping fee charged to the asset, as a different contract from the *rahn*. However, in actual sense both contracts are interrelated. The interaction between the contracts can be observed that the presence of safekeeping fee (*ujrah*) is due to the presence of *wadī'ah yad ḍamānah* contract. On the other hand, the existence of *wadī'ah yad ḍamānah* is due to the existence of *rahn* contract, and finally, the *rahn* existed because of *qarḍ* contract. Hence, the contract started with *qarḍ*, and without the *qarḍ* contract, there is no concluded mortgage contract and no safekeeping fee can be charged. Hence, the mortgagee cannot treat safekeeping fee independently from the *qarḍ* contract, but it is interrelated with the mortgage. By charging for safekeeping fee, it is similar as taking benefit from the loan given, which is prohibited by the Sharī'ah. In this respect, it is observed the safekeeping charged is merely a *ḥilah* to obscure the direct charge on the loan amount given.<sup>668</sup> Hence, the reason that the imposition of the charge is based on the service of the safekeeping and not to the loan is an invalid justification from the perspective of the Sharī'ah. In other words, the loan is given provided the customer agrees to pay the safekeeping fee, which exceeds the actual storage cost incurred by the bank, as compared to the safety box.<sup>669</sup>

Furthermore, the arrangement of *ujrah* and *wadī'ah yad ḍamānah* is seemed similar to a combination of sale and loan. This can be evidenced that *ujrah* is an exchange contract and *wadī'ah yad ḍamānah* is a non-exchange contract. As we have already noted, the combination of exchange and non-exchange is prohibited under the Sharī'ah provision. The contract of *wadī'ah yad ḍamānah* has been recognized by SACBNM, as a loan contract in its resolution.<sup>670</sup> As *wadī'ah yad ḍamānah* is a type of *qarḍ* contract; hence, the creditor, i.e. Islamic bank is not entitled to possess any extra benefit from the borrower. *Ujrah* in this respect is regarded as an extra benefit to the creditor and if the creditor is committed to do that, then it is considered violating the principle of *ribā*. Both contracts are interrelated and this can be noticed that the loan is

<sup>668</sup> Asmadi Mohamed Naim, "Sistem Gadaian Islam (*Islamic Mortgage System*)," *Islamiyyat* 26, no. 2 (2004): 39-57; Abdul Khir, *et. al* "Critical Appraisal," 16-17.

<sup>669</sup> See for example Maybank offers the service of safe deposit boxes, where a box size 3 "x 5" x 20 "which is estimated can store the weighing 50 grams, only charged RM80 per year, as compared with the keeping the asset in the *rahn*, which charges RM420. Please see the example above. Maybank, "Bank Fees, Safe Deposit Boxes," accessed 20 February 2013, [http://www.maybank2u.com.my/mbb\\_info/m2u/public/personalDetail04.do?channelId=&cntTypeId=0&cntKey=ACC09.07&programId=ACC09-BankingFees&chCatId=/mbb/Personal/ACC-Accounts/](http://www.maybank2u.com.my/mbb_info/m2u/public/personalDetail04.do?channelId=&cntTypeId=0&cntKey=ACC09.07&programId=ACC09-BankingFees&chCatId=/mbb/Personal/ACC-Accounts/)

<sup>670</sup> BNM, *Sharī'ah Resolutions*, 101-102; Abdul Khir, *et. al*. "Critical Appraisal," 16.

only given by the bank, when the borrower pledges his asset and pays the safekeeping fee. Principally, mortgage asset is allowed by the Sharī'ah to guarantee the debt. However, what is practiced by the bank, to charge commercially the safekeeping fee, is an attempt to change the relationship between *qarḍ* and *rahn*. The attached stipulation to pay some amount of safekeeping fee is considered, as the unknown benefit (*jahālah manfa'ah*) to the creditor. However, it is not an issue, if the mortgaged asset is stipulated into the loan contract to secure the repayment of the debt, without requesting any payment, or exchange of benefit in terms of the safekeeping fee's payment. This is because this practice to request mortgage is in tandem with the requirement of the loan contract, as prescribed in the Sharī'ah.

The other issue is the arrangement between *rahn* and *wadī'ah* is contradictory to each other. In *rahn* contract, the mortgaged asset only serves as a security contract and it must be returned when the customer pays back his debt. On the other hand, in *wadī'ah*, the safe keeper should return the asset kept with him by the owner of the asset, if he is requested to do so by the owner at any time.<sup>671</sup> The reason for such stipulated rules is that *wadī'ah* contract is classified, as non-binding contracts (*'uqūd ghayr lāzim*), where the owner of the safekeeping asset can terminate or request the asset back, as he wishes. Meanwhile, *rahn* contract is binding contract (*'uqūd lāzim*) that aims to support and secure the amount of debt owed, and the owner of the mortgage asset is not allowed to terminate the contract or request the asset at any time.<sup>672</sup> In the principles of combination of contracts stated in the AAOIFI's standards, it is stipulated that the contracts combined should not contradict with each other, and if they are opposing with each other, the combination is considered null and void.

However, this is contrary with the current structure of *rahn* contract applied by Bank Rakyat, where the same object serves as the mortgage and the safekeeping asset. Essentially, the purpose of the *wadī'ah* contract is to protect the asset under the trust of the safe keeper, therefore in this case, *wadī'ah* contract is not required, as the asset is already secured in the protection of the mortgagee under the *rahn* contract. The insertion of *wadī'ah* contract in the structure is actually to merely justify the charge of the safekeeping fee or *ḥilah*, which is an unnecessary element, embedded in the structure of

<sup>671</sup> Islamic Fiqh Academy of OIC, *Majallah Majma' al-Fiqh al-Islāmī* (Jeddah: OIC, 1996), 9, vol. 1, 667. vol. 7, 198; see also OIC Fiqh Academy, *Majallah Majma' al-Fiqh al-Islāmī* (Jeddah: OIC, 1995), 9th Convention, resolution no. 86 (9/3).

<sup>672</sup> See article 31/1, AAOIFI, *Al-Ma'āyīr al-Shar'īyah*, 697.

the product. If the the creditor wishes to charge some fees, as there is some operational cost to keep the mortgage asset, the fees must be actually cost and transparent, which is not related to the loan amount. In this respect, the *rahn* structure appears similar to loan with interest charged, however it has been modified so that it is acceptable to the Sharī'ah. This product is another *ḥiyal madhmumah* (impermissible legal artifice), which is used by the bank to avoid the prohibition of *ribā*. The structure of the product could not be regarded as *makhraj* (jurisprudential exit), since it has changed the established legal ruling of the contracts involved in the product. The nature of *wadī'ah yad ḍamānah* and *rahn* should be non-commutative contracts, but they have been transformed to commutative contracts, which have deviated from the original status of the contracts.

Therefore, it is recommended that the bank needs to employ other alternatives to generate profit and returns for the bank. The jurisprudential exit for this product is that they can offer a business based on a safekeeping box that the bank could charge any relevant fees for the services. In this case, this is probably not a lucrative business, but it is a way out from the legal artifices, which are prohibited by the Sharī'ah. The Islamic bank is supposed to venture out from the obscured transactions and assume a risk similar to entrepreneur, who sells and purchases goods and services in the market place, instead of engaging risk free business, such as *rahn* or *qard*.

## 5.4. Case III: Islamic House Financing under Forward Lease

### 5.4.1. The concept of forward lease

A forward lease or *al-ijārah mawsūfah fī al-dhimmah* can be regarded as a new concept that has been recently applied in Malaysian Islamic banks.<sup>673</sup> Many terms have been used to indicate the concept in the Arabic nomenclatures, such as *ijārah al-dhimmah* (forward lease), *ijārah wāridah 'ala al-dhimmah* (lease contract based on responsibility) or *'aqd 'ala manfa'ah fī al-dhimmah fī syai' mawsūf bi sifat* (a contract

<sup>673</sup> The AAOIFI for example does not obliquely address as a specific concept or topic in the standard. While, the SACBNM has issued a specific resolution to highlight the issue when one bank has asked as to whether the concept is permissible to be applied with *mushārah mutanāqishah* (*diminishing partnership*). The contract has been approved to be applied in developing Islamic financial products and services by the AAOIFI and the SACBNM on 16 May 2002 and 24 May 2007, respectively. See Paragraph 3/5, AAOIFI, AAOIFI, *Al-Ma'āyir al-Shar'iyah*, 142; SACBNM, *Sharī'ah Resolutions*, 16.



that benefits based on responsibility of asset or property is attributed with specifications). These terminologies nonetheless carry the same meaning to the former, which is a lease contract with benefits that will be prepared in the future.<sup>674</sup> It is different to the conventional *ijārah* because the benefits of the latter can be consumed immediately once the contract is concluded, whereas the benefits of forward lease will be available only in the future. This is because the asset to be utilized by the lessee is not yet owned by the lessor at the contractual session, where the contract is concluded. It is based on a promise undertaking of the lessor to deliver the asset based on detailed specifications, value, and time of availability, where the lessee can benefit it in the future.<sup>675</sup>

It is also different from the contract of *salam*, since in forward sale, there is no requirement for the contractor to pay beforehand the rental payment. However, payment in advance is obligatory in the *salam* contract. The contract has been argued is similar to contract of *istiṣnā*. This is because the buyer cum lessee has some flexibility and freedom to defer the rental payment until the objects or services rendered by the seller. However, it is different from the *istiṣnā* that is always associated with the object to be manufactured. In the contract of forward lease, the seller sells benefits to be utilized, not the physical object.<sup>676</sup> It seems that both principles of contracts, i.e. *salam* and *istiṣnā* cannot be adopted as the principles of forward lease because the nature of the two contracts is different from the forward lease and it could be regarded as a new contract.

#### 5.4.2. Sharī'ah rulings of forward lease

The main principle of the contract is that the lessee must describe in detail the benefits in the lease agreement that he will utilize. This agreement also depends on the ability of the lessor to deliver the asset to be utilized. If the lessor cannot deliver the asset, at the exact time and place with the specified features, the lessee has the right to reject or replace for substitution or to terminate the contract. It is not a requirement for

<sup>674</sup> Aḥmad Muḥammad Mahmud Nassir, "The Parameters of Forward Ijārah and its Application in Financing Services in Islamic Financial Institutions," accessed on 1 March 2013, [www.isra.my](http://www.isra.my); Securities Commission, "Ijārah Mawsufah Fi al-Dhimmah (Forward Lease)," *Malaysia ICM: Quarterly Bulletin of Malaysian Islamic Capital Market* 4, no. 4 (December 2009): 2.

<sup>675</sup> Securities Commission, "Ijārah Mawsufah Fi al-Dhimmah, 2.

<sup>676</sup> Some of the requirements of *istiṣnā* contract are the commissioner has a right to defer the payment of the sale's price until the asset is delivered, or pay is in accordance to the progress of the project's development and the subject matter must be details in terms of its quantity, quality, time and place of delivery. See furthermore, AAOIFI, *Al-Ma'āyir al-Shar'iyah*, 181-189.

the lessee to pay in advance the rental payment, but the lessor may ask the lessee to pay it beforehand. If the rental payment is made prior to the deliverability of the asset to be benefited from, the contract is considered as *salam* contract (forward sale). If that is the case, then all the rules associated with *salam* contract must be followed.<sup>677</sup>

There are some contentions among contemporary scholars concerning forward lease, whether it takes the rules of *salam* (forward sale), conventional *ijārah* or a new type of contract. According to Abū Ghuddah, he explains that forward lease is similar to the conventional *ijārah*. In conventional *ijārah*, the lessor is committed to providing a thoroughly described benefit; either the benefit is in the form of an object (e.g. car or house) or human services (e.g. teaching or tailoring). It is required for the lessor at the contractual session to own the physical asset that will provide the benefit. However, if the asset is not yet available then this is known as a forward lease. In this contract, it is not required for the lessor to own the physical asset to be consumed or the human services at the contractual session (*majlis al-‘aqd*) in which the benefits can be provided in the future.<sup>678</sup> Both contracts are considered as binding (*lāzim*) contracts, thus, the parties involved may not terminate the contract unilaterally.<sup>679</sup> Therefore, based on these, he regards that forward lease has similar characteristics as compared to the conventional *ijārah* and all the principles of conventional *ijārah*.<sup>680</sup>

Furthermore, Abū Ghuddah adds that forward lease lately became an alternative contract for leasing an asset, which is not existent. This is because in forward lease, the lessor is permissible to charge rental before the subject matter for lease is existent, as long as he regards that the rental payment is a debt for him until he delivers the subject

<sup>677</sup> Some of the requirements of *salam* contract are the rental payment must be made in advance and the assets to be sold must be described very details on its quantity, quality, time and place of delivery. See furthermore, AAOIFI, *Al-Ma‘āyir al-Shar‘iyyah*, 165-169.

<sup>678</sup> Abdul Sattar Abū Ghuddah, “Practical Application of al-Ijārah al-Mawsūfah fī al-Dhimmah (Forward Ijārah),” accessed on 1 March 2013, [www.isra.my](http://www.isra.my).

<sup>679</sup> Ibid.

<sup>680</sup> According to the Ḥanafīs, conventional or particularized *ijārah* (*ijārah mu‘āyanah*) is defined, as an exchange contract for transfer of benefit or usufruct in return for compensation. The Mālikīs define it as the transfer of usufruct for a price, where they restrict the term *ijārah* to a contract for utilization of human services and what can be moved, excluding ships and animals; whereas they use the word *kira’* specifically for contracts for the utilization of land, buildings, ships and animals. Other scholars, however, consider *kira’* and *ijārah* to be synonymous. On the other hand, the Shāfi‘īs defines it as a contract on a defined usufruct capable of being given out with a permissible known or fixed price. Meanwhile, the Ḥanbalīs define it as a contract on a permissible defined usufruct or benefit that will be utilized gradually throughout a defined period on a defined property or defined in liability (forward) for a price, or a contract on a permissible service for a known price. In this respect, most of Islamic law’s schools of thought define *ijārah* in general term, where there is no requirement for either the object or service utilized must be owned or possessed in the contractual meeting, thus, according to Dr. Abdul Sattar, the contract of *ijārah mawsufah bi dhimmah* is no different with the term of conventional *ijārah*. Ibid.

matter to be utilized by the lessor. Furthermore, it is also not a requirement for the lessee to pay the rental in advance and it can be deferred. However, these elements have triggered the issue of *bay' al-kālī bi al-kālī* (sell a debt for a debt; both counter values are delayed), where both components (subject matter and price) are delayed. Lease contract is considered as one type of sales contracts, and the delay of both components is prohibited in Sharī'ah in order to avoid any *gharar* in the transaction. However, Abū Ghuddah argued that for forward lease, there is an exceptional situation, where both components can be delayed. However, he did not strongly justify his assertions by quoting any Qur'ānic verses or prophetic traditions or rationales in order to support the decision.<sup>681</sup>

Contrary to Abū Ghuddah, Mahmud Nassir considers that forward lease falls under the principle of mixed contract of *salam* and conventional *ijārah* contract, thus, part of the principles of both contracts are applied. For example, the lessee is required to pay in advance the full amount of the price at the contractual session. The lessor is required to deliver the asset to be utilized similar to the terms and conditions in the contractual session. If the lessor violates the prescribed conditions, the lessee may have options, either to retain in the contract until all the requirements are satisfied or terminate the contract. The lessor is allowed to use the rental payment made by the lessee for personal purposes and it is regarded as a debt to the lessor. If he fails to deliver the object to be benefited, then he is required to render it back to the lessee. The lessee also can take a mortgage from the lessor in order to secure the contract. If the lessor fails to provide the object or service to be benefited, the lessee has a right to sell the mortgaged asset in the market place to get the equivalent value of the benefits provided by the lessor.<sup>682</sup>

In this regard, it can be concluded that both scholars agree that the contract of forward lease is subsumed under the conventional *ijārah*, where all the requirements of the latter contract must be maintained in the former. However, the difference between the two opinions is that Abū Ghuddah does not stipulate that the lessee must pay the rental in advance, since the object to be utilized, as benefit is not delivered yet. However, Mahmud Nassir argues that the lessee is required to pay in advance, as it is analogy

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<sup>681</sup> Abū Ghuddah justifies that there are no particular sources can be referred to defend the contract. For those who justified it through *salam* contract, would apply all the conditions of *salam* except the advance payment in full, they would rely upon the evidence for *ijārah* in the absolute sense to be evidence for this particular form of it. Ibid.

<sup>682</sup> Mahmud Nassir, "The Parameters of Forward Ijārah," 7-16.

to the *salam* contract, where the object is delayed. If both counter values are delayed, then it is equivalent to sell a debt for a debt, which is prohibited in the Sharī‘ah. To conclude the discussion, the author personally agrees with the contention of Abdul Sattar that both counter values can be delayed. The purposes are to ease the transaction of the society and to remove hardship, as this requirement becomes a customary practice (*‘urf*) in the modern business transactions and it is in tandem with the objective of Sharī‘ah.

The AAOIFI and the SACBNM also have briefly discussed the contract and its application in Islamic financial services. The AAOIFI in its standard of the article 3/5 stated that; “an *ijārah* contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications, even if the asset so *described is not owned* by the lessor. It is not a requirement of this forward lease that the rental should be paid in advance as long as the lease is not executed according to the contract of *salam*. If the lessee receives an asset that does not conform to the description, then he is entitled to reject it and demand an asset that conforms to the description”.<sup>683</sup> Meanwhile, the SACBNM resolved that the contract is permissible, based on the classical justification made by Muslim jurists that classified *ijārah* into two types; *ijārah* over the usufruct of a readily available asset or *ijārah* over the usufruct of an asset undertaken to be made available (*dhimmah*) and analogical reasoning (*qiyās*) of *salam* contract.<sup>684</sup>

#### 5.4.3. The case of Kuwait Finance House’s house financing

Kuwait Finance House (Malaysia) (KFHM) is among the three foreign Islamic banks, which have been given license by the government to operate in Malaysia since 2005. The bank is also part of KFH Group, which was established in Kuwait 1977. KFH has since expanded regionally in the Middle East, as well as in Europe and Asia. KFH has business operations in Bahrain, Turkey, Jordan, Saudi Arabia, Malaysia, Singapore, and Australia as well as affiliates in the United Arab Emirates, Oman, and Bangladesh. It was called as the 'Harvard of Islamic banks' in the 2007 issue of Forbes magazine, KFH has earned global recognition, having received numerous prestigious local and international awards, such as the Most Outstanding Islamic Consumer Prod-

<sup>683</sup> AAOIFI, *Al-Ma‘āyir al-Shar‘īyah*, 142.

<sup>684</sup> BNM, *Sharī‘ah Resolutions*, 17

uct-KFH-Gold Account-i at Kuala Lumpur Islamic Finance Forum (KLIFF) 2011 and Best Investment Bank (Asia) at Islamic Business and Finance Awards 2011. The bank offers numerous Shari‘ah-based financial products and services under Corporate and Investment, Commercial, and Retail and Consumer Banking as well as Treasury and International Business. In addition, the bank also has established KFH Asset Management Sdn Bhd to provide asset and fund management activities, encompassing private equity, alternative investments, and unit trusts.<sup>685</sup>

The contract of forward lease is utilized for property under construction, since it is argued that it can solve the financing of an item, which does not exist yet during the contractual session. This is different from normal sale transaction because the main principle of the contract, subject matter must exist at the contractual session to avoid *gharar*. Throughout the period of construction, the lessor/ the bank may ask the lessee (customer) to pay a certain portion of pre-agreed lease rental as a forward lease. The rental paid will be considered as a debt to the lessor until the delivery of the leased asset, i.e. home, to the lessee. The ownership of the asset remains to the lessor and it will be transferred to lessee at the end of leasing period or once full settlement is made by the lessee through gift or sale. The contract is mostly targeted at individuals, who aim to purchase property under construction landed or non-landed residential properties such as link and semi-detached house, bungalow, apartment, condominium, and bungalow lots for dwelling or business purposes. The calculated amount of financing is based on the fixed or variable rate as determined by the bank from time to time, and the credit profile of the applicants. The home and property to be financed will be mortgaged as a security of the financing.<sup>686</sup>

The contract involves combination of two contracts, namely *istiṣnā’ mawazi* (parallel commission sale) and *ijārah muntahiyah bi tamlik* (leasing ended with acquisition), which are contracted in a separate transactions.<sup>687</sup> It is regulated under the Shari‘ah resolutions issued by the SACBNM and the Hire-Purchase Act 1967.<sup>688</sup> The flows or structures of the product used for house-financing product are as follows:

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<sup>685</sup> Kuwait Finance House (Malaysia) Berhad, accessed on 6 January 2013, <http://www.kfh.com.my/kfhmb/>.

<sup>686</sup> Kuwait Finance House (Malaysia) Berhad, “Product Sheet Disclosure,” accessed on 15 October 2013, [http://www.kfh.com.my/kfhmb/ep\\_images/v2/documents/products/pds/PDS-IMFZ-Mortgage-v7.pdf](http://www.kfh.com.my/kfhmb/ep_images/v2/documents/products/pds/PDS-IMFZ-Mortgage-v7.pdf)

<sup>687</sup> BNM, *Shari‘ah Resolution*, 158.

<sup>688</sup> Nurdianawati Irwani Abdullah, “Islamic Hire-Purchase in Malaysian Financial Institutions: A Comparative Analytical Study,” (PhD diss., Loughborough University, 2005), 24

- (i) The customer identifies the interested property or house to be purchased under construction and the price, for example, is RM 100,000 from the developer.
- (ii) Based on section 31, the Hire-Purchase Act 1967 (the HPA 1967), the customer has to pay 10% instalment of the price and now he has the ownership of the house. He then applies for financing facility to pay the remaining balances of the price through KFHM.
- (iii) The bank studies the credit profile and the capability of the customer to pay the facility, before it releases the financing. The amount of the financing is based on the credit profile and capability to pay back. If the customer obtains a good credit background from the assessment, the bank will release the full amount of the financing, i.e. 90 % of the price.
- (iv) Once the bank approves the financing, the customer has to sign a contract that he sells the house to KFHM based on the contract of *istiṣnā' mawāzī* (parallel manufactured sale).<sup>689</sup> This contract means, once the developer completes the construction instead of delivering the house to the customer; it will deliver to the bank. Consequently, all the liabilities, such as debt and ownership risk are transferred to the KFHM, and the customer is absolved from the responsibility of the house.<sup>690</sup>
- (v) Afterwards, the customer has to enter another contract, namely forward lease with KFHM. In this respect, the customer becomes a lessee and KFHM becomes a lessor. The responsibility of KFHM is to ensure that the house will be delivered and the lessee can benefit from the asset. The bank also must ensure that the customer will pay the rental up until the house is delivered. Meanwhile, the developer's responsibility is to deliver the house on the accurate time, as prescribed in the initial contract.
- (vi) Once the construction is completed by the developer, KFHM will continue to lease the house, but under the concept of *ijārah muntahiyah bi al-tamlīk* (leasing end with acquisition) until the customer has settled the full amount of rental

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<sup>689</sup> Contractual agreement consists of two series of separate *istiṣnā'* contracts, whereby the first *istiṣnā'* contract is between the customer and the bank, and the second contract is between the bank and the supplier, who is responsible to deliver the item. For further information on *istiṣnā' mawāzī*, refer AAOIFI, *Al-Ma'āyir al-Shar'īyah*, 188-189.

<sup>690</sup> Although it is stated that the parties sign parallel *istisna*;, the fact is that the both parties conclude a 'novation agreement'. It refers to an agreement made between the lessee and lessor that after the client buys an asset from the vendor/dealer, the customer agrees to transfer the rights, obligations, and ownership of the asset to the financier/lessor.

payment. Afterwards, KFHM will transfer the house's ownership to the customer through *hibah* (gift) contract.<sup>691</sup> Normally the house under construction will be completed 1-3 years after the agreement, depends on the development and progress of the construction. If the developer delays the delivery the house then, normally he will be fined and the amount of fines is charged in accordance to per day delayed (see Figure 7).

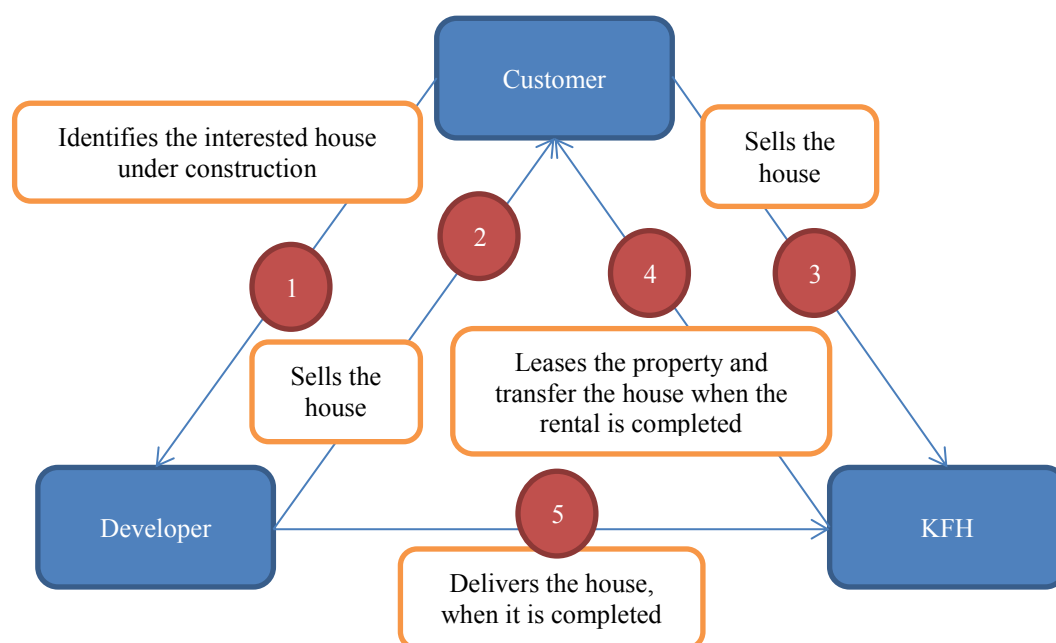


Figure 7: The Structure of House Financing under Forward Lease

KFHM in this respect offers two types of programs of entrance into acquisition of the financing, namely zero entry cost (ZEC) and non-zero entry cost (NZEC). Under the ZEC, all expenses, i.e. legal fees and stamp duty on financing agreement and valuation fees, shall be borne by the bank. However, it excludes all costs related to the transfer of the property's ownership. Meanwhile, under the NZEC, all expenses mentioned above are paid by the customer. The difference between both is that in terms of the profit charged. For the ZEC package, the range of rate, if the amount of financing between RM250K –RM500K, then the charge is 2.30% per annum, and if the amount of

<sup>691</sup> *Ijārah muntahiyah bi tamlik* as defined in the AAOIFI's standard is this contract is combination of two contracts, involving a contract of lease and the lessee's promise to purchase the leased asset after the lease is completed. This concept relies on the sharia principle that a contract is a two-party relationship binding on both parties whereas a promise is solely binding on the person or party who gives it, the promisor. AAOIFI, *Al-Ma'āyir al-Shar'īyah*, 141.

financing is above than RM500K, then the rate is 2.40% per annum. On the other hand, for NZEC, the amount of profit charged is cheaper than ZEC, as it excludes the amount of all expenses, which must be paid, if the customer subscribes ZEC. The charges for the financing amount between RM250K –RM500K, is only 1.90%, while if it is above than RM250K, the charge is 2.10% per annum. The rate of profit is based on Based Financing Rate (BFR).<sup>692</sup> The profit rate charged is calculated monthly on a reducing balance method.<sup>693</sup> KFHM, on the other hand, will approve the financing up to 90% of the property value, subject to the debt servicing ratio (others debts in other financial institutions) of the customer that is not more than 60%. Meanwhile, the financing tenure is given up to 35 years or until age of 70 years, whichever is earlier. (The profit rates charged are indicated in the table 9).

| Package     | Range                |                       |
|-------------|----------------------|-----------------------|
| Non-ZEC/FEC | RM250K - <RM500K     | RM500K and above      |
|             | BFR -2.30% per annum | BFR – 2.40% per annum |
| Package     | Rate                 |                       |
| ZEC         | RM150-250K           | >RM250K               |
|             | BFR-1.90% per annum  | BFR – 2.10% per annum |

Table 9: Profit Rate of Asset Acquisition Financing-I under Forward Lease

In the event of default, KFHM will take the following actions. Firstly, the bank will charge penalty (*ta'wid*) of 1% per annum on the overdue instalment or any other approved charges by the BNM or the Association of Islamic Banking Institutions in Malaysia (AIBIM). The bank also will revise the financing rate, which will result in a higher instalment amount to be paid by the customer due to restructuring or reschedul-

<sup>692</sup>Based Financing Rate (BFR) is a minimum profit/interest rate calculated by financial institutions based on a formula that takes into account the cost of institution of funds and other administrative costs. The BFR is usually the same amongst major banks. Adjustments to the BFR are made by banks at the almost same time; although, the BLR does not adjust on any regular basis. Usually adjusted (at the time in correlation to the adjustments of the OPR), which is determined by Bank Negara Malaysia (BNM) during Monetary Policy Meeting. Banks in some countries use the name "Prime Rate" or "Prime Lending Rate" to refer to their Base Lending Rate. BFR is used to price products including mortgage financing, personal financing, credit card, and overdraft facility. Omar, *et. al.* "An Islamic Pricing Benchmark,"

<sup>693</sup> Reducing Balance Method is the depreciation is charged at a fixed rate like straight line method (also known as fixed installment method). However, the rate percent is not calculated on cost of asset but based on the book value of asset. The book value of an asset is obtained by deducting depreciation from its cost. The book value of asset gradually reduces because of charging depreciation. Since the depreciation rate per cent is applied on reducing balance of asset, this method is also called as *reducing balance method* or *diminishing balance method*. See the calculation of this method in Accounting Explanation, "Reducing Balance Method of Depreciation," accessed 13 March 2013, [http://www.accountingexplanation.com/reducing\\_balance\\_method\\_of\\_depreciation.htm](http://www.accountingexplanation.com/reducing_balance_method_of_depreciation.htm).



ing of financing repayment. The bank also will report to local credit bureau of the history of default of the customer. In this respect, the customer may face the difficulty of obtaining future credit and banking facilities with other financial institutions. The last resort that can be taken by the bank is a legal action against the customer for his failure to pay the outstanding amount due. Consequently, charges will be incurred to the customer as well as the historical record of financial statement for future credit and banking facilities, up to be declared for bankruptcy status.

#### 5.4.4. Sharī'ah issues

It is observed that the structure of forward lease offered by KFHM is contradictory to the Sharī'ah principle of ownership. This product is regulated under the Hire-Purchase Act 1967 (HPA 1967) in which some part of the provision of the act is contrary to the Sharī'ah principles. It is stated previously that the bank and customer must sign the contract of *ijārah muntahiyah bi al-tamblik* (see step IV) in a separate transaction. It is done in order to avoid the prohibition of combination of two contracts in one contract, which is prohibited by the Prophet. However, under the HPA 1967, once the customer signs the contract, the asset is automatically owned by the customer. This triggers a conflict with Sharī'ah law, since the asset is not yet owned by the customer.<sup>694</sup> It can be questioned as to whether the customer has signed an *ijārah* or sale contract.

The ownership of the property has been delivered to the buyer can be shown through the reading of Section 20, the Sale of Goods Act 1957. It is stated that once the customer rendered 10% of the house's price, the ownership is directly owned by the customer.<sup>695</sup> Then, the customer sells to the bank and the bank becomes the real owner of the house. This is considered as the owner of the property has transferred the ownership to the new owner. However, this is not realized when the customer applies for the facility from the bank. Based on the previous judgment in the case of *BSNC Leasing Sdn Bhd v Sabah Shipyard Sdn Bhd and Ors* (2000), the judge decided that once the contract of hire-purchase is signed, the asset is directly owned by the buyer, whereas it

<sup>694</sup> It is stated in the definition of HPA 1967, "hire-purchase agreement includes a *letting of goods with an option to purchase and an agreement for the purchase* of goods by instalments (whether the agreement describes the instalments as rent or hire or otherwise)." There are two agreements concluded by the contracting parties, an option to purchase, and an agreement for the purchase. Hire-Purchase Act 1967, 8.

<sup>695</sup> Section 20, Sale of Goods Act 1957

should be the seller from the perspective of Sharī'ah. Thus, the bank is not the real owner of the asset.<sup>696</sup> This ambiguity is evidently seen in the registration of ownership's title of the house, where it does not indicate that the bank is the real owner of the property, but it is the customer.<sup>697</sup> Furthermore, the property is owned by the customer can be shown through the action of the bank to charge/pledge the property. It is not reasonable since the property is not yet transferred from the bank to the customer. It is seemed that the bank pledges its own asset. In reality, the property has been transferred to the customer; therefore, it is valid for the bank under the common law of Malaysia to pledge the asset. This is contrary to the principles and objectives of the contract.

The other problem is the subject matter sold does not exist. When the customer initiates to sell the house under the current structure, the property sold is still under construction. In other words, the subject of the sale does not exist yet, when the contract of sale is concluded. However, this has been argued by Sharī'ah scholars that the selling of subject matter, which is not existed yet, can be performed, as long as there is a certainty in delivering the subject matter. However, based on the abandoned cases of housing project in Malaysia, it raises some doubt whether the argument is still valid to be used in this case. If the current system could not guarantee the delivery of the house, hence, it is contrary to the principles and objectives of the Sharī'ah.<sup>698</sup>

Furthermore, the agreement signed between the bank and customer is observed to be unfair to the latter. The bank does not provide, either in the product sheet terms or contract, any remedies, if the promised property is unable to deliver to the client. Therefore, it is an unfair agreement for the customer because there is no legal remedy for the failure of delivery of the property to customer. This indicates that the bank only thinks to solve the default of rental payment by the customer, but not to the property, which may not be delivered. The bank is only interested in the financing and does not act as a lessor or the legal owner of the property.

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<sup>696</sup> *BSNC Leasing Sdn Bhd v Sabah Shipyard Sdn Bhd and Ors* (2000) 1 AMR 1141; see also Rosman, "Hiyal wa Makhārij, 285; Abdullah, "Islamic hire-purchase in Malaysian financial institutions, 23-24.

<sup>697</sup> The SACBNM, however, recognized this practice, where it argued that Sharī'ah recognizes the concept of beneficial ownership, although it seems conflict with the classical position of ownership. Bank Negara Malaysia, *Sharī'ah Resolutions*, 6.

<sup>698</sup> Nuarrual Hilal Md. Dahlan and Sharifah Zubaidah Syed Abdul Kader Aljunid, "Sharī'ah and Legal Issues in House Buying in Malaysia Legality of Bay' Bithaman-Al-Ājil ('BBA') with Special Reference to Abandoned Housing Projects," *Pertanika Journal of Social Science and Humanities* 19, no. 2 (2011): 349 – 361

<sup>698</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 113.

The other issue is related to the rate of rental where the bank does not provide in detail about the framework of the rate of rental that will be charged by the bank. In Malaysia, the rental is determined by the bank based on annuity table, where it has the equivalent of profit and principal portion. The profit portion represents the lease, while the balance represents the principal repayment. For a non-banking scenario, lease rentals are normally benchmarked against prevailing rate of rental of assets of similar nature. When the bank offers forward lease, the rental does not exhibit the true prevailing rental rate of the property. Instead, it is based on the prevailing cost of funds and market interest rates charged, which can be linked to conventional loans.<sup>699</sup> The bank cannot determine the rental rate based on the prevailing market rate because the bank would be unable to reimburse back the cost of fund acquired, if the market rate is lowered than the rental charged by the bank. The rental paid by the customer does not reflect the actual market lease value. Consequently, this product is unable to achieve the objective of genuine Islamic lease financing under the principle of Islamic banking.

In addition, it is observed that the structure still has the salient feature of *ribā* is still existent. The structure of the product is structured based on *bay' al-ṭinah*, which has been prohibited by the majority of Muslim jurists due to it is similar *ribā*. However, the contract has been recognized in Malaysia. The similarity can be noticed, when the customer initiates to sell the house under construction to the bank with cash and buy it back gradually through paying the rent and finally ending up with the purchase. This is similar to *bay' al-ṭinah* structure, where someone sells an item with cash and subsequently he then buys it back with deferred payment. The impact of using the contract is that it would not be able to realize the objectives of sale transactions in the Sharī'ah, i.e. to utilize the benefits of the subject matter by the buyer and to receive fair compensation by the seller. This is because the contract is arranged fortuitously to circumvent the prohibition against *ribā*. Furthermore, it is obviously stated that in the HPA 1967 that the terms charges- i.e. total interest charged on the hire-purchase facility, which is calculated based on a flat rate on the amount financed over the duration of the facility-is applied into the contract.<sup>700</sup> This causes an issue of Sharī'ah, since the interest is pro-

<sup>699</sup> Khaled Morad Amer and Ninasrin Radenarmad, "Innovation In Islamic Banking: The Practical Application of Forward Ijārah and Its Issues And Challenges," (paper presented at 2<sup>nd</sup> ISRA Colloquium 2012, "Islamic Finance in a Challenging Economy: Moving Forward, Suasana Kijang, Bank Negara Malaysia, 27<sup>th</sup> November 2012).

<sup>700</sup> Bank Negara Malaysia, "Terms Charges," accessed on 16 October 2013, [http://www.bankinginfo.com.my/04\\_help\\_and\\_advice/0406\\_glossary/glossary.php?intPrefLangID=1&](http://www.bankinginfo.com.my/04_help_and_advice/0406_glossary/glossary.php?intPrefLangID=1&)

hibited in any transaction. Therefore, it is found that the product still could not avoid *ribā*.

In this respect, the legal framework and structure of the product need some improvements and modifications. In order to streamline the HPA 1967 with the Sharī'ah principles, the act must be modified so that the issues addressed can be resolved. If it could not be modified, then a new Islamic Hire-Purchase Act should be promulgated.<sup>701</sup> Meanwhile, for the subject matter, which does not exist yet, it has been argued that the matter is permissible based on the justification provided by Ibn Taymīyah (d.1328), Ibn Qayyim (d.1350) and the SACBNM. It is permitted on the condition that the seller is capable to deliver the object to the buyer.<sup>702</sup> However, Md. Dahlan and Aljunid (2011) argued that many cases in Malaysia, where the developers fail to deliver the house to the buyer and the trend of the failure is rising every year.<sup>703</sup> In this respect, the regulator and government should strictly regulate the development of the house to ensure justice and equitable treatment to the buyers.<sup>704</sup> To avoid that the structure be similar to *bay' al-īnah*, the bank itself buys the house from the developer and sells it to the customer after the customer identifies the house. This structure is dissimilar to the *bay' al-īnah*, since the bank purchases from the developer and assumes the risk of ownership. Finally, to mitigate the risk of ownership, the customer must sign a unilateral undertaking that he will purchase the house, once the bank purchases it.

## 5.5. Conclusion

In conclusion, it is observed that there is no difference with conventional banks in the approaches taken by the Islamic banks to develop their products. The banks still employ the mechanism of *hiyal* as the main approach in structuring their products and services in order to evade the circumvention of *ribā*. Although there are some *hiyal*, which are allowed under the Sharī'ah, namely *makhārij*, the employment of the method

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<sup>701</sup> This suggestion has been voiced out by many researchers, such as Hama (2004) and Abdullah (2005); however, the regulator still not yet takes any proactive action to remedy the flaws of the Act. Zakariya Hama, "Hire Purchase Transaction: A Comparative Study in Islamic and Malaysian Law," (Master of Comparative Law diss., International Islamic University of Malaysia, 2005), 172-189; Abdullah, "Islamic hire-purchase in Malaysian financial institutions, 23-25.

<sup>702</sup> Muhammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions* (Islamabad: Sharī'ah Academy, 2001), 37-40.

<sup>703</sup> Md. Dahlan and Syed Abdul Kader Aljunid, "Sharī'ah and Legal, 349 – 361

<sup>704</sup> Bank Negara Malaysia, *Sharī'ah Resolutions*, 113.

is not strongly justified by Islamic bankers resulting the confusion, whether the products developed under the prohibited *hiyal* or otherwise. Hence, it is not surprising that Islamic bankers prefer to develop their products based on the structure of controversial contracts such as *bay' al-ṭinah* or organized *tawarrūq*, since it is the easy way to replicate *ribā*-based conventional products offered in the market. The approaches taken have deviated from the proposed idea of Siddiqi (1983) that equity financing be the main basis for product development. Islamic banks in Malaysia prefer the approach of debt financing, as proposed by Ismail (1992). The findings support the assertion by previous scholars, such as El-Gamal (2006), Hamoudi (2007), Nienhaus (2007), Muneeza *et. al.* (2011) and Rosman (2008) that Islamic banking products are based on *hiyal*.

In addition, the research finding shows that product developers in Islamic banks are only concerned with the contractual forms rather than the substances of the contracts applied. The contract is only employed to justify the ends or results of the products developed. Hence, any contract that can produce similar result to circumvent the prohibition of *ribā*, will be used to structure a product. This can be best illustrated in *rahn*, where a contract *wadī'ah yad ḍamānah* is merely formulated to justify the safe-keeping fee, although there is no relationship between *rahn* and *qard*, which serves the main contract in the product. This finding advocates the previous studies done by El-Gamal (2006), and Kuran (2004) that Islamic finance attempts to preserve the form rather than substance of the contract.

The main reason is that Islamic banks have to take into account the interest of their depositors and stakeholders that seek for positive profits and good return. This was explained by scholars, such as Humayon and Presley (2002), Nienhaus (2010) and Khan (2013) that most Islamic banks are risk-averse group, which expect some return to the deposit and capital invested. Therefore, the fund should be prudently managed by the banks to avoid any loss. Debt-financing facility becomes the choice since it provides security and guarantee to the deposited money and capital. Furthermore, it is not relevant for the banks to structure Islamic banking products that are based on equity financing on credit-purchased and personal financing, since they are consumption on the fund, which is different with equity-financing aimed at venturing business in order to

obtain profits, except for house financing that can be based on *mushārah* *mutāqīṣah* financing.<sup>705</sup>

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<sup>705</sup> Further explanation, see Humayon and Presley, “Lack of Profit and Loss Sharing in Islamic Banking, 3-18; Nienhaus, “Capacity Building in the Financial Sector, 1-26; Khan, *What is Wrong with Islamic Economics*, 339-340.

## CHAPTER 6: CONCLUSION

### 6.1. Summary of the Findings

The conventional banks in the world began banking business a few hundred years ago, in which their main businesses are taking deposits and giving loan to customers with interest (*ribā*). However, this is different to the operation of Islamic banking, where the institution is mainly developed based on the principles of Sharī'ah and Islamic economics. In the Islamic economic system, Islamic banking is not only about abstaining from charging interest or fulfilling the requirements of banking product, but it also aims to realize socio-economic objectives and the sustenance of a just and ethical society. It must balance between the objectives of the bank as a financial intermediation to maximize profit and ensure efficiency and the needs of society, which demand for justice and fairness in economic transactions. These ideas are translated via developing products that can produce sustainable impacts and fulfilling society's needs. The main contract proposed to operate the bank is centered on the profit-loss-sharing basis, which has been claimed to be capable in ensuring socio-economic justice.

In developing Islamic banking products, three elements are essentially important; namely the process of product development, the legal and regulatory framework and the Sharī'ah aspects. The process of product development must be carefully managed to keep track of the various details including planning, organizing, controlling and leading the different phases of the process. The legal elements deal with the modern regulatory framework and the supervision of the activities and operations, as well as the process of product development of Islamic banks by the regulator, i.e. the central bank. Meanwhile, the Sharī'ah aspects refer to the religious framework to ensure that the concept of product development is consistent with the Sharī'ah principles and requirements. These three elements must be well understood by product developers so that the products developed would be efficient and viable in the market.

The paramount concern in the process of developing Islamic banking products is to ensure that the products comply with the contractual forms of Sharī'ah requirements. These include the fulfilment of the pillars and the conditions of the contracts, as well as observing the limits of the Sharī'ah, i.e. the products must be free from the prohibited elements, such as *ribā*, *gharar*, and *maysir*. In addition to the Sharī'ah requirements, the product developers also have to take into consideration the modern Islamic

banking requirements, such as customer requirements, pricing, risk management, and product features. However, it is argued that by using this approach, i.e. fulfilling the contractual forms, the product developers apparently ignore the substance and economic objectives of the contracts applied. For example, the use of sell and repurchase contract (*bay' al-ṭinah*) will ignore the Islamic economic objective. Among the Islamic economic objectives of sale are to transfer the ownership and the new owner will benefit from the ownership of property purchased. However, under this contract, the new owner does not have any opportunity to benefit from the advantages of the property since the contract is synthetically arranged to allow *ribā's* usurpation. Hence, this transaction has violated the objective of the economic transaction delineated in the Sharī'ah.

The objective of the process of product development in Islamic banking is similar to conventional banking, which is to achieve the economic efficiency. The main difference is that the goal of product development is to achieve the profits based on the Sharī'ah compliance by employing Sharī'ah contracts and methods in product development. Various techniques have been used, such as replication of conventional products, product augmentation, and mutation, combination of contracts, novel contract, customer preference, and market segmentation, to develop Islamic banking products. It is shown that classical Islamic nominated contracts have been employed to develop financial products by altering some of its features and characteristics in order to suit the modern banking requirements. Although the positive aspect of the efficiency and effectiveness of conventional banks may be adopted in Islamic banking, the process of imitating the characteristic of *ribā*, which exists in the conventional product, is not acceptable, since it may not contribute to achieving the objectives of Sharī'ah and Islamic economics.

Nonetheless, Islamic banking products in Malaysia have been criticized over its Islamicity, which are unable to fulfil the objectives of Sharī'ah and Islamic economic principles. Hence, this study decided to focus two specific aspects, which are critical in ensuring the Islamicity of Islamic banking products, namely the legal and regulatory challenge and the issue of *hiyal*. For the issue of legal and regulatory framework, the Malaysian government recently has enacted the new Islamic Financial Services Act 2013, which offers specific regulation on Islamic banking procedures and the Central Bank of Malaysia 2009, which provides more power to the Sharī'ah Advisory Council (SAC) to interpret Sharī'ah law. However, the study found that the act is insufficient to



ensure the Islamicity of the products, since they only serve as administrative and supervisory laws, and not the substantive laws of Sharī'ah principles. The substantive laws that regulate Islamic banking products are conventional laws, which are dubious to be coherent and compatible with the Sharī'ah principles (e.g. Hire-Purchase 1967). Consequently, the products still could not escape from being labelling as unIslamic. Furthermore, the court system that adjudicates Islamic banking cases is civil courts, which are normally applying the principles of common law as well as the judges in the civil court are trained in common law and not Sharī'ah law. The main problem common law with Sharī'ah law is that some of the underlying principles of the former are incompatible with the latter. Islamic banking products apply Sharī'ah principles, which require competent judges in deciding the cases of Islamic banking in the court. The consequence of incompetent civil judges on Sharī'ah laws in adjudicating Islamic banking cases caused many legal decisions, which have been decided, are contradicted to the Sharī'ah precepts.

Meanwhile for the issue of *hiyal*, the method has been long regarded as the casuistical technique for escaping the prohibition against *ribā* by embedding the element of interest into contract without violating the letter of the prohibition in the classical scholarly discussions. Normally, *hiyal* have a negative connotation and the person using the method is considered to be concealing intention to deceive the rules of Lawgiver. Classical Muslim jurists have divided *hiyal* into two divisions, namely, *hiyal muḥarramah* (prohibited legal artifices) and *hiyal maḥmudah* (permissible legal artifices). The former refer to a legal disposition, which is originally permitted, but the performer of *hiyal* does not intend to realize its original legal consequences, which is set by the Lawgiver. However, the performer attempts to overturn them to the other legal consequences and rulings in order to achieve his objectives. Meanwhile, the latter are a legal disposition intended to achieve greater benefits or to eliminate harms that happened or will happen that does not result in any changes to the original legal consequences prescribed by the Lawgiver. The latter are also known as *makhārij*, which are employed generally to the situation where someone faces with a *ḍarūrah* (necessity) and/or difficult circumstances that could not be avoided. It has been argued that if the *makhārij* are not employed into the situations, then the performer would not achieve his objectives, in which his objectives must be consistent with the objectives of Sharī'ah; preservation of religion, life, intellectual, progeny and property. The former are prohibited, while the latter are permitted. However, the dichotomy of these legal dispositions has confused

the practitioners and they ostensibly apply both terms interchangeably in developing Islamic banking products. Consequently, the contract that is considered as impermissible *hiyal* is applied to the same status as *makhārij*, as it happened to the contract *bay' al-ʿīnah* and organized *tawarrūq*. Both contracts are considered prohibited *hiyal* and not as *makhārij*, since they are normally employed to circumvent the prohibition against *ribā*.

In order to integrate the theoretical framework with the practical approach in developing Islamic banking products, this study examined three case studies. The chosen products are Islamic credit card based on *ujrah* concept, Islamic mortgage operated under the concept of *rahn* and house financing based on the concept of forward lease. It was observed that the approaches taken by the Islamic banks examined to develop the products although they are Sharīʿah compliant approved by SACBNM, are actually inconsistent with the ideal concepts of developing Islamic banking products, namely to maintain the economic participation and socio-economic justice. The main approach engaged by Islamic banks to develop Islamic banking products is mostly based on debt-based product, whereby *hiyal* instruments serve the main principle. *Hiyal* are applied due to the approach's ability to circumvent *ribā* as applied in the conventional banks. Although these products can be categorized under *makhārij*, nonetheless the banks did not strongly justify the employment of the method with sound Sharīʿah explanations resulting the products developed seem similar to the prohibited *hiyal*-products. Furthermore, the replicated products of conventional banks that are based on debt financing dominate the market as compared to equity-based financing products, which are promoted by Islamic economic theorists.

It was observed that among the main reason these three banks adopted *hiyal* instruments of conventional banking is the risk-averse factor. In this respect, the approach of *hiyal* is a secured method of ensuring the rates of return of the banks' investment. Hence, Islamic banks have to stay away from adding high-risk investments to their portfolio, which will endanger their expectation of higher return. In addition, as corporate banks in which profitability and positive return are the main objectives, the banks have to take into account the interest of their shareholders and depositors that demand positive returns quarterly or annually on their investments to the banks. If the banks prioritize to offer products based on profit-loss sharing, which are risky, the returns from the products would be uncertainty. This may threaten stakeholders and de-

positors's expectation, who aim for positive returns. Therefore, the true objective of Islamic banking as in the theoretical framework cannot be fully realized.

## 6.2. Recommendations

The study asserts that the innovation process of product development in Malaysian Islamic banks must be extensively exercised by the product developers. Product development in Islamic banking has to be extended, beyond replicating conventional instruments to other methods and techniques. Various ways can be practiced as long as the approach is not contrary to the established principles of Sharī'ah. This can be best illustrated in the case of parallel forward sale (*salam mawāzī*), whereby the classical form of the *salam* contract has been transformed into this new approach. Under classical form, only one party will provide a commodity ordered by a new buyer. In the modern parallel forward sale (*salam mawāzī*), there are two parties involved in supplying the commodity. The bank will act as the first party; however, the bank as a financier is not a producer of the commodity will not directly deliver the commodity to the customer. Instead, the bank will appoint the real supplier or producer of the commodity to deliver it to the customer. This innovative and modified contract is able to solve the problem of Islamic banks that intend to introduce forward sale in their line of products.

The study proposes that the scope of innovation in Islamic banking have to be expanded to explore new creative solutions of the critical financial problems faced by Islamic banks and customers. The aspects of *maṣlahah* (public interests) and Islamic economic objectives must be observed to realize the effective implications of the product towards the economic and social compass. Thus, creativity plays an important role in product development of Islamic banking because it may produce a product that at once conforms to both the customer's needs and the Sharī'ah precepts. Creativity in this respect is different from the innovation. Creativity is a thinking or skill that helps generate ideas or the ability to make connections of various concepts that result in ideas. It is a skill exercised through the process of innovation. Whereas, innovation is the sequential process of identifying problems, needs or opportunities, to generate ideas to address the problems, to move from the best ideas to completion of the process, and to generate the best values and result from the ideas.

The study recommends that the regulator shall enact the substantive Islamic commercial laws, which are purely Sharī'ah-based principles in which they will address various Sharī'ah issues of Islamic financial services. It is inadequate for the regulator to pay the attention to the administrative laws, whereas the substantive issues of Islamic commercial law are neglected. Consequently, the root problem of Islamic banking could not be settled and the products will be questioned from time to time by people since they are incompatible with the ideal concept of developing Islamic banking products. To promulgate the substantive Islamic commercial law, thus, it is proposed for the regulator, especially the BNM to enact the resolutions of the SACBNM, as the basis and the legal code for Islamic commercial law. The regulator is only required to systematize and organize *fatwā* issued by the council in systematic articles similar to the conventional legal codes, statutes, or acts, as practiced in Malaysia. These resolutions can be systematically arranged to form the first Islamic commercial act to serve the Islamic banking and finance industry.

In order to ensure the transparency, integrity, independence, confidentiality and professionalism of the Sharī'ah Advisory Council's members in deciding Sharī'ah rulings, the member of SAC at the Islamic banking institutions shall maintain the principles of the professional ethics of codes of conduct to avoid the discrepancy of the ethical works in deciding any Sharī'ah decision. These principles refer to the attributes and characteristics that Sharī'ah scholars must be fully independent in deciding any Sharī'ah decisions and responsible for any Sharī'ah decisions that have been made. Furthermore, they also must keep the banking information as confidential, discipline and qualified personnel, especially post-qualification of Islamic law/ Sharī'ah and Islamic banking. To ensure the implementation of these principles, the regulator also shall impose strict implementation of penalty for the Islamic banks that fail to abide the Sharī'ah principles.

For the issue of *hiyal*, this study suggests that product developers in Islamic banks shall maintain the consistency between the form and substance of the contract. The process of product development shall start with the substance of economic exchange of the contract before it is followed with the form i.e., the contract/agreement. The consideration of both elements is necessary for the approval of the final product. If both are acceptable, then the product is fully Sharī'ah compliant. It is observed that in developing Islamic banking products, only the contractual form is taken into full consideration for approval process without considering the substance of contracts. The

contractual form is simply a means, and if the means is employed in order to reach an illegitimate product, then it is not acceptable. Furthermore, the product developers must consistently differentiate between the concept of *hiyal* and *makhārij*, since both legal dispositions are apparently dissimilar. Furthermore, it is recommended for the Malaysian Islamic banks to avoid *bay' al-ʿīnah* concept as a tool for product development in Islamic banking. The main reason of the inappropriateness of the contract is that the contract is seen as a method to camouflage the prohibition of *ribā*. Moreover, the contract has not been proven to contribute to the economic well-being of the society and is still ostensibly not free from the tyrannical feature of *ribā*. Other methods of financing, such as *mushārah mutanāqishah*, parallel forward sale (*salam mawazī*) or parallel commission sale (*istiṣnāʾ mawazī*) may become viable alternatives.

To encourage the economic participation among society, thus, the model of Islamic banks must be changed. This ambitious objective only can be realized through a model of social capital. The aim of Islamic banks funded through social capital, is different from corporate banks, since the objective of the banks is to assist community in society or that based on cooperation among individuals of society that intends to develop a project/activity based on mutual and cooperative system. Therefore, it is reasonable for Islamic banks to widely offer products based on equity and profit-loss sharing. In this regard, the objective of the Islamic banks is not only profitability, but to encourage the economic participation among the shareholders involved, to realize profits and to assume loss collectively in the economic activity. Under the model, the shareholders have to be prepared in case of losses are incurred in the course of the economic activity that they engage in. To ensure the transparency and integrity of the capital is utilized, Islamic banks are responsible and accountable to report their economic activities annually or quarterly. Under this model, the objective of Islamic banking of achieving the socio-economic justice and economic participation among the society could be materialized. However, the objectives of Islamic banks will not be achieved under the corporate model adopted by the current Islamic banks. Under the current model, Islamic banks are regarded as individual or corporate entities that aim to satisfy their personal achievement, profitability, and satisfaction. This is contrary to the proposed Islamic bank's model by the Islamic economists that is based on a communal unit, which aims to assist members in the society.

### 6.3. Contributions

Having discussed the main findings and solutions of the issue, there are several contributions of the present study, especially to the research of product development in Islamic banking. Firstly, the study deeply delved into the theoretical framework of product development in Islamic banking, especially on the approaches to developing Islamic banking products from the Sharī'ah perspective. In addition to the many studies that have been done, the present study offered valuable and beneficial information on the conceptual framework of product development from the Sharī'ah perspective. The basic comprehension of this conceptual framework of product development is essentially imperative to analyze further the application of product development in real practices. Secondly, the study critically examined some challenges of the legal and regulatory issues faced by Islamic banks in developing Islamic banking products. By exposing some of the issues, it is hoped that this will assist the practitioners to comprehend the nature and constraints in developing a product that is consistent with the Sharī'ah and the Islamic economic principles.

Furthermore, the study offered a comprehensive examination of the issue of *hiyal* that becomes a complex matter in developing Islamic banking products. The study specified useful information concerning the extent to which *hiyal* can be applied to product development in Islamic banking. The study also consolidated various opinions on *hiyal* and to define the term meticulously, the differences between *hiyal* and *makhārij* in Sharī'ah and Islamic banking were discussed. Finally, the study examined three case studies in order to illustrate some examples on how Islamic banks may structure their products and to identify some key Sharī'ah issues involved in the products. The illustrations may provide beneficial information for the Islamic bankers and points to the need for more attention to the aspect of the Sharī'ah issues, features, structure, and design in developing Islamic banking products.

### 6.4. Future Research

Despite the researcher's utmost effort to provide inclusive, reliable and significant investigation on the topic of product development in Islamic banking, undeniably

the study has experienced several limitations, which may be regarded as research gaps for future research. Firstly, the research employed qualitative method, which studies from the perspective of Sharī'ah. Furthermore, the sources are limited to examine official documents issued by the regulator, acts and statutes related to Islamic banking, legal documents, news, internet sources, practitioners' papers, and journals. This study can be improved and expanded by employing other methods, such as quantitative or mix methods between qualitative and quantitative methods. The future study also may utilize other sources, such as interviewing key personnel or figures engaged in the process of developing Islamic banking products; such as the regulators, Sharī'ah advisors, product developers, or risk management's officers. The involvement of these key figures, probably may contribute new insights into product development in Islamic banking. With respect to time span, this study only utilizes data and information obtained from October 2010 - October 2013. The findings of the research may be more vigorous, if the data is expanded, for example since the establishment of Islamic banks. Finally, this study has limited the scope of research to the Malaysian Islamic banking context, therefore it could not be generalized to other regions or countries that have different approaches and legal systems that influence and influence the process of product development. Despite it has many constraints and limitations, the present study established evidences on the concept and issues related to product development in Islamic banking in the context of the Malaysian Islamic banking. It also contributed to the existing literature by providing rich literature works as well as real case studies on product development in Islamic banking. Therefore, this research stands out beyond the superficial understanding or theoretical assumptions of the issues investigated.

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